88-1424

Supreme Court, U.S.
FILED
FEB 15 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. _____

In The

Supreme Court of the United States

October Term, 1988

THE STUART-JAMES COMPANY, INC. and
MARC N. GEMAN,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

**On Writ Of Certiorari To The
District Of Columbia
Circuit Court Of Appeals**

PETITION FOR WRIT OF CERTIORARI

HART & TRINEN
DONALD T. TRINEN
CHRISTA D. TAYLOR
1624 Washington Street
Denver, CO 80203
Telephone: (303) 839-0061

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

The Securities and Exchange Commission had affirmed disciplinary sanctions imposed on Petitioners by the Board of Governors of the National Association of Securities Dealers, Inc., which had held that the Petitioners wrongfully had conducted a securities business while in violation of the net capital requirements of SEC Rule 15c3-1 (17 C.F.R. §240.15c3-1). The Rule requires broker/dealers to deduct a certain amount from their firm's net capital upon entering into "firm commitment" underwriting agreements with stock issuers. The Rule permits them, however, to reduce the deduction by "unrealized profits". Petitioners had included in their calculations of such unrealized profits a nonaccountable expense allowance received from the issuer, which the SEC disallowed, thus causing a net capital deficiency.

The District of Columbia Circuit Court of Appeals denied the Petitioners' request for reversal of the SEC's order on the grounds that the SEC's interpretation of the phrase "unrealized profits" was reasonable and did not constitute an abuse of discretion. The appeals court noted, however, that the SEC's interpretation of the phrase was "not a model of procedural fairness" because it was applied for the first time in an adjudicatory proceeding in which it affected petitioners substantively and adversely.

Petitioners believe that the appeals court erred in upholding the SEC's order because the order's effect was to make the SEC's net capital rule more stringent than promulgated, thereby depriving Petitioners of their constitutional right to fair notice of what forbidden conduct to avoid. Was the order of the Columbia Circuit Court of Appeals in error?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

OPINION BELOW 1

JURISDICTION 2

SECURITIES AND EXCHANGE COMMISSION RULE INVOLVED 2

STATEMENT OF CASE 2

REASONS FOR GRANTING WRIT 3

APPENDIX ..... App. 1

TABLE OF AUTHORITIES

Page

CASES:

Chamber of Commerce of the United States v. Occupational Safety and Health Administration, 636 F.2d 464 (D.C.Cir. 1980) 8

Herron v. Heckler, 576 F.Supp. 218 (D.Cal. 1983) 9

In Re Lowell H. Listrom Co., SEC Release No. 34-16750 (1980) 7

Morton v. Ruiz, 415 U.S. 199 (1974) 9

Oliver v. U.S. Postal Service, 696 F.2d 1129 (5th Cir. 1983) 7

L.R. Willson & Sons, Inc. v. Donovan, 685 F.2d 664 (D.C.Cir. 1982) 7

U.S. v. Heller, 726 F.2d 756 (Emergency Ct.App. 1983) 8

CONSTITUTIONAL PROVISIONS:

U.S. CONST. amend. XIV, §1 3

STATUTES:

1. 5 U.S.C. §551 *et seq.* 9

2. 5 U.S.C. §552(a)(1) 9, 10

3. 5 U.S.C. §553 10

4. 15 U.S.C. §78o(c)(3) 4

5. 28 U.S.C. §2101(c) 2

TABLE OF AUTHORITIES–Continued

Page

MISCELLANEOUS:

17 C.F.R. §240.15c3-1 (SEC Rule 15c3-1) 2, 5

17 C.F.R. §240.15c3-1(c)(2)(viii) 2, 3

17 C.F.R. part 241 9

No. _____

In The

Supreme Court of the United States

October Term, 1988

THE STUART-JAMES COMPANY, INC. and
MARC N. GEMAN,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit entered in this matter on September 20, 1988. A petition for rehearing was denied November 17, 1988.

OPINION BELOW

The September 20, 1988 opinion of the Court of Appeals, whose judgment is herein sought to be

reviewed, is reported at 857 F.2d 796 (D.C.Cir. 1988) and is reprinted in the separate Appendix to this Petition, pp. 1-12. The prior decision by the Securities and Exchange Commission is also reprinted in the Appendix at pp. 14-20.

JURISDICTION

The judgment of the Court of Appeals was entered on September 20, 1988, and a petition for rehearing was denied on November 17, 1988. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §2101(c).

SECURITIES AND EXCHANGE COMMISSION RULE INVOLVED

The rule involved is SEC Rule 15c3-1 (17 C.F.R. §240.15c3-1(c)(2)(viii)), which is reproduced in the Appendix at pp. 21-84.

STATEMENT OF THE CASE

On April 23, 1985, the District Business Conduct Committee ("DBCC") for District 3 of the National Association of Securities Dealers, Inc. ("NASD") brought a disciplinary proceeding under its rules of fair practice, alleging that Stuart-James and Geman had wrongfully conducted a securities business while in violation of SEC Rule 15c3-1, "the net capital rule" (Joint Appendix, submitted to the appellate court in conjunction with the parties' briefs, hereinafter referred to as 'J.A.' at 1-3).

Following an extensive hearing, the DBCC directed that the disciplinary complaint be dismissed (J.A. 4-13). However, prior to such action becoming final, the Board of Governors of the NASD, on its own motion, reviewed the decision, reversed the dismissal, and imposed a fine and censure on Stuart-James and Geman (J.A. 14-19). Stuart-James and Geman sought review before the SEC, which issued its opinion on June 15, 1987, finding that Stuart-James and Geman had violated the net capital rule and affirming the NASD's imposition of sanctions (J.A. 20-24). The District of Columbia Circuit Court of Appeals affirmed the SEC's order.

REASONS FOR GRANTING THE WRIT

The question on appeal is whether the Court of Appeals erred in holding that the SEC had not abused its discretion and had not been "unreasonable" in ruling that a "nonaccountable expense allowance" payable to the underwriter in connection with a "firm commitment" underwriting was not an "unrealized profit" as that term is used in the SEC's net capital rule, 17 C.F.R. §240.15c3-1(c)(2)(viii). The SEC's belated interpretation of the phrase had the effect of putting Petitioners unfairly in violation of the net capital rule with attendant sanctions.

The interpretation had never been communicated to the public and, therefore, cannot serve as a basis for imposing discipline on the Petitioners. The SEC should not be allowed to deprive the Petitioners of the constitutional right to due process under the guise of protecting investors, U.S. CONST. amend. XIV, §1. Investors are

better served, as are we all, by laws that give notice and fair warning of prohibited conduct.

In a firm commitment offering, the underwriter buys the securities from the issuer and assumes the risk of selling them. Once such a commitment is made, the Rule requires the underwriter to immediately deduct the equivalent of 30% of such undertaking from its net capital. Such a "haircut", however, will be reduced by offsetting "unrealized profit" attributable to the commitment.

The issue in this case is what constitutes "unrealized profit". Is it limited to 10% concession on the commitment as the SEC maintains, or is it the 10% concession, plus other profit, which Stuart-James received from the stock's issuer at the closing of the deal, as Petitioners maintain? The difference is crucial in that under the SEC's interpretation, Petitioners have violated the net capital rule, whereas under Petitioners' interpretation no violation has occurred. The finding of a violation puts Stuart-James's license to sell securities in jeopardy in numerous jurisdictions.

The Rule was promulgated pursuant to §15(c)(3) of the Securities Exchange Act of 1934 (15 U.S.C. §78o(c)(3)), which directs the SEC to make rules to establish minimum financial responsibility requirements for broker/dealers to demonstrate financial strength and liquidity, as calculated in accordance with formulas set forth in the Rule, and it is a violation of the NASD Rules of Fair Practice to conduct a securities business, even for a moment, when it cannot demonstrate compliance.

A.

Appellants' Have Complied with SEC Rule 15c3-1 Under its Plain Terms

Under the plain terms of the Rule, Petitioners have complied therewith. The pertinent part of the Rule reads as follows:

> Rule 15c3-1(c)
>
> (2) The term "net capital" shall be deemed to mean the net worth of a broker or dealer, adjusted by
>
> (viii) [a 30% deduction for open contractual commitments] . . .
>
> Provided that the deduction with respect to any single commitment shall be reduced by the unrealized profit, in an amount not greater than the deduction provided for by this section (or increased by the unrealized loss), in such commitment . . . "

The SEC has not defined the term "unrealized profit" by rule, by decision, or by any published interpretation which would put a broker/dealer on notice that the term intends to cover only "concessions", neither has any court defined that phrase. "Profit", as the term is commonly understood, means a gain one realizes from engaging in business, and it includes compensation accruing to an entrepreneur for assuming the risk in a business enterprise.

There is no legitimate factual basis to include the concession in "unrealized profits" but exclude the allowance, since both further the goal Congress has set, namely, to insure a firm's financial strength. In the instant case, the company had negotiated with USEL for *two* sources of profit, both accruing at the time the deal was closed on November 1, 1984. The first was a concession of

$174,000 Stuart-James could earn if it sold all the securities it had purchased from USEL. As was pointed out at the hearing, Stuart-James would not realize this amount as profit because it would have to pay out one-half of it as commissions to the salespeople who did the actual selling of the securities (J.A. 131), thus the pure profit to the underwriter would amount to no more than $87,000. Yet, the SEC customarily allows the *entire* concession to be deducted from the haircut (J.A. 22).

The second, and more significant item of profit, was the expense allowance which, at a minimum, amounted to $120,000, and actually was $138,000 (J.A. 131). It is true that the company would use it to cover its expenses in making the offering, but such expenses were mathematically predictable at the time of closing as being far below the allowance received, actually amounting to $18,612 (J.A. 128, 146). Therefore, Stuart-James could predict with confidence that it would reap a sizeable profit from its expense allowance.

A certified public accountant, who specializes in accounting for brokerage firms, testified that nonaccountable expense allowances are always items of profit for companies who "buil[d] them into their deal to make money" (J.A. 127-128) and that, from an accounting standpoint, there is no reason to treat concessions differently from such allowances, because both mean revenue to the company, and both are considered by the NASD in its calculations of maximum allowable compensation (J.A. 99, 128). Geman testified that from a broker/dealer's point of view, there was absolutely no difference between the concession and the allowance, and that he was not aware of any "interpretation" indicating otherwise (J.A.

92, 101-106). No testimony to the contrary was presented by the NASD.

When interpreting a regulation, the plain language of the regulation controls, absent a clearly expressed legislative intention to the contrary. *Oliver v. U.S. Postal Service*, 696 F.2d 1129 (5th Cir. 1983). The purpose behind the net capital rule is Congress' desire to regulate the financial soundness of broker/dealers. *In Re Lowell H. Listrom Co.*, SEC Release No. 34-16750 (1980). That soundness is tied to a firm's profits derived from a commitment. Petitioners contend that the Rule unambiguously provides for calculations of the net capital which take into account "unrealized profits" of whatever character, not just concessions.

An agency should not be allowed to construe a regulation to mean what the agency might have intended but did not adequately express. *L.R. Willson & Sons, Inc. v. Donovan*, 685 F.2d 664 (D.C.Cir. 1982). In the instant case, it would have been a simple matter for the SEC to say in the Rule that a gross haircut could be reduced only by "concessions", by defining the term "unrealized profit", or by any other permissible means. However, such was not done. The Court of Appeals opined that the agency could and should have foreseen the necessity to define the term to ensure fairness (slip opinion p. 10, Appendix) but, nevertheless held the belated definition by the SEC "not unreasonable", and not an abuse of discretion.

Petitioners believe that the term "unrealized profits" should be given its everyday meaning and should not be subject to SEC interpretation narrowing that meaning. The law is clear that an interpretation cannot change the

provisions of a regulation. *Chamber of Commerce of the United States v. Occupational Safety and Health Administration*, 636 F.2d 464 (D.C.Cir. 1980) and if the rule is unambiguous, it must be applied as written. *U.S. v. Heller*, 726 F.2d 756 (Emergency Ct.App. 1983). Thus, even if an interpretation actually existed, which was conceded by the government that it did not, it would be void.

B.

An Agency's Interpretation Which Does Not Meet the Requirements of the Administrative Procedure Act is Not Binding on Appellants

In imposing discipline on the appellants, the NASD Board of Governors plucked from thin air a finding that the Rule had "customarily been interpreted" to allow only the inclusion of the concession as unrealized profit and that appellants' position was "at variance with past interpretations" "by relevant authorities" (J.A. 16-17, 19). Testimony presented on behalf of the NASD clearly established that there was no interpretation of any kind concerning the Rule, neither by the NASD nor by the SEC, much less one of long standing. The fact that the NASD staff had to call the SEC in order to find out what its own position should be is hardly consistent with the existence of a "well-known" or "long-recognized" pronouncement.

In essence, the NASD and SEC seek to set up a standard requiring constant individual inquiries by broker/dealers to determine if a given rule means what it says, or means something else concocted in secret on the spur of the moment by a staff member. Such is not acceptable under constitutional safeguards.

In order for agency interpretations to be binding on those whose rights are affected, they must be promulgated in accordance with the requirements set forth in the Administrative Procedure Act ("APA"), 5 U.S.C. §§551, *et seq*. The APA was adopted to provide, *inter alia*, that administrative policies affecting individual rights and obligations be promulgated pursuant to certain stated procedures to avoid the inherently arbitrary nature of unpublished *ad hoc* determinations. *Morton v. Ruiz*, 415 U.S. 199 (1974). 5 U.S.C. §552(a)(1) specifically states in pertinent part that:

> "Each Agency shall separately state and currently publish in the Federal Register for the guidance of the public
>
> > (D) . . . statements of general policy or interpretations of general applicability formulated and adopted by the agency."

In 1976, Congress amended §552(a)(1) to add sanctions for agency noncompliance by providing that no person could be adversely affected by any agency matter required to be published but not so published, unless such person actually knew of an unpublished provision, see *Morton v. Ruiz, supra, Herron v. Heckler*, 576 F.Supp. 218 (D.Cal. 1983). In the instant case, appellants did not know of the alleged SEC interpretation of "unrealized profits", thus, this exception is not available to the SEC.

The SEC is well aware of the APA requirements regarding official interpretations, as is evident by glancing at 17 C.F.R. part 241, which consists of a long list of "Interpretative Releases" under the Exchange Act from 1934 to the present with references on where to find the release in the Federal Register. Several of these releases

interpret phrases contained in the net capital rule. For instance, Release No. 34-9922, January 18, 1973, 38 F.R. 1737, interprets "customers", "excess margin securities" and other terms "in the interest of assisting brokers and dealers in complying with the Rule's provisions". Petitioners submit that the DBCC took the correct position when it recommended in its decision, in which it dismissed the charges against Stuart-James and Geman, that the SEC should formally state what it means by "profit" for the benefit of the securities industry before sanctions should be imposed on anyone (J.A. 12-13).

It is too plain to require citation that proceedings affecting professional licenses and registrations, just as criminal statutes, must provide fair notice of the conduct which is prohibited. The position taken here by the government has never been communicated to NASD members either by the SEC or by the NASD. That such an "interpretation" could seriously be urged as a legitimate basis for discipline is simply repulsive to any decent notion of fair play and due process. The Court of Appeals erred in holding that the SEC had not violated §§552 and 553 of the Administrative Procedure Act.

DATED this 15th day of February, 1989.

HART & TRINEN
/s/ Christa D. Taylor
DONALD T. TRINEN
CHRISTA D. TAYLOR
1624 Washington Street
Denver, CO 80203
Telephone: (303) 839-0061

Attorneys for Petitioners
The Stuart-James Company, Inc.
and Marc N. Geman

APPENDIX A

Notice: This opinion is subject to formal revision before publication in the Federal Reporter or U.S.App.D.C. Reports. Users are requested to notify the Clerk of any formal errors in order that corrections may be made before the bound volumes go to press.

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued April 14, 1988 Decided September 20, 1988

No. 87-1402

STUART-JAMES COMPANY, INC., and MARC N. GEMAN, PETITIONERS

v.

SECURITIES & EXCHANGE COMMISSION, RESPONDENT

On Petition for Review of an Order of the Securities and Exchange Commission

---

Donald T. Trinen, with whom *Christa D. Taylor* was on the brief, for petitioners. *Ralph V. DeMartino* also entered an appearance for petitioners.

Lucinda O. McConathy, Special Counsel, Securities and Exchange Commission, with whom *Daniel L. Goelzer*, General Counsel, *Jacob H. Stillman*, Associate General Counsel, *Paul Gonson*, Solicitor, and *Batya Roth*, Attorney, Securities and Exchange Commission, were on the brief, for respondent.

Bills of costs must be filed within 14 days after entry of judgment. The court looks with disfavor upon motions to file bills of costs out of time.

Before: Mikva, and D. H. Ginsburg, *Circuit Judges* and Jackson,* *District Judge.*

Opinion for the Court filed by Circuit Judge Mikva.

MIKVA, *Circuit Judge:* The Stuart-James Company is a securities broker-dealer. Marc N. Geman is its executive vice-president. They petition for review of an order of the Securities and Exchange Commission ("Commission" or "SEC") affirming a decision of the National Association of Securities Dealers ("NASD") censuring them and imposing a $500 fine for violating the Commission's net capital rule. Stuart-James is a member of NASD. Petitioners challenge the Commission's interpretation of the term "unrealized profit" in the net capital rule, and propose a different interpretation of the phrase according to which their actions would have been in conformity with the rule's net capital requirements. In addition, they contend that the Commission violated provisions of the Administrative Procedure Act ("APA") by failing to publish its interpretation of the rule. Because we believe that the Commission's interpretation of "unrealized profit" is a reasonable one and that it acted within it discretion in affirming the NASD order, we deny the petition for review.

I. BACKGROUND

A. *Origin of the Case*

Petitioner Stuart-James entered into an underwriting agreement with U.S. Electronics Group ("USEG") on

---

*Sitting by designation pursuant to 28 U.S.C. § 292(a).

November 1, 1984. Stuart-James undertook a firm-commitment underwriting of $1.74 million of the $2 million securities offering. As is done in firm-commitment offerings, Stuart-James purchased the securities in advance from USEG and then undertook to resell them to individual customers. According to the underwriting agreement, Stuart-James would purchase the securities at a 10% discount from the public offering price. This 10% discount, or "concession," would constitute Stuart-James's compensation for its role in the transaction.

The NASD requires its members to submit underwriting plans to it for advance review. In September, Stuart-James had initially submitted a plan whereby it would underwrite all $2 million of the USEG offering, but the NASD rejected the plan as submitted because it found that Stuart-James would not have had enough capital to support an offering of that size. In late October, Stuart-James submitted a new plan according to which it would underwrite only $1.74 million of the offering, and the NASD approved the plan. The offering became effective on November 1.

On November 13, the NASD reviewed Stuart-James's October financial report and changed its view. It found that Stuart-James's net capital at the time it entered into the USEG agreement was not in fact sufficient to undertake the underwriting while conforming to the net capital rule. The NASD informed Stuart-James of its analysis and asked Geman, the executive vice-president, to submit a new net capital computation. Working with the information submitted by Stuart-James, the NASD calculated that Stuart-James had a net capital deficiency of $81,685.

The following April, the NASD District Business Conduct Committee ("DBCC") filed a complaint against Stuart-James and Geman, charging them with conducting a securities business without maintaining sufficient net capital as required by Rule 15c-3. It found that the company had violated the rule, but dismissed the complaint because it held that mitigating circumstances existed. On review, the NASD Board of Governors affirmed the DBCC's finding that Stuart-James had violated the net capital rule, but reversed the decision to dismiss the complaint. The Board imposed sanctions in the form of an official censure and a $500 fine. The SEC reviewed the Board's findings and upheld both the censure and the imposition of sanctions.

B. *The "Unrealized Profits" Dispute*

The disagreement between the Commission and Stuart-James stems in large part from their differing interpretations of the net capital rule. The Securities and Exchange Act of 1934 authorizes the SEC to impose minimum financial responsibility requirements on brokers. It requires brokers to operate within

> such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers. . . . Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum fianancial responsibility requirements for all brokers and dealers.

15 U.S.C. § 780(c)(3) (1982). Pursuant to Rule 15c-3, the SEC has promulgated various regulations imposing minimum capital requirements upon brokers. The net capital rule was designed to engender investor confidence in brokers by requiring them to maintain a specific percentage of liquid assets in relation to indebtedness. 17 C.F.R. § 240.15c3-1(a) (1987). *See Touche Ross & Co. v. Redington*, 442 U.S. 560, 570 (1979) (net capital rule is "the principal regulatory tool by which the Commission and the Exchange monitor the financial health of brokerage firms and protect customers from the risks involved in leaving their cash and securities with broker-dealers.").

The net capital rule states that a firm's "aggregate indebtedness" may not exceed 1500% of its "net capital." 17 C.F.R. § 240.15c3-1(a). The regulations set forth a formula for calculation of net capital that works on three variables: (1) the excess net capital before an underwriting commitment is taken on; (2) the offering's gross "haircut"; and (3) the broker's "unrealized profit" on the offering. The calculation begins with any net capital that a firm has that is not already being used to offset indebtedness. From this amount is subtracted the appropriate "haircut" for a given transaction – that is, the specific percentage of the offering price that the regulations state must be deducted from net capital for that kind of securities offering. The haircut, however, is itself offset by the firm's "unrealized profit" from the transaction. 17 C.F.R. § 240.15c3-1(c)(viii). A firm is thus within the bounds of the net capital rule so long as its excess net capital and unrealized profits exceed a transaction's haircut.

The parties to the instant case disagree over only one component of the formula, but it is enough to make the

difference between whether appellants operated within the requirements of the net capital rule. Both sides agree that before it entered into the underwriting agreement with USEG Stuart-James's aggregate indebtedness was $4,086,371.77. For that figure not to have exceeded 1500% of net capital – and thereby have put Stuart-James in violation of the net capital rule – it was necessary that the firm's net capital remain above $272,424.92. It is further undisputed by the parties that the firm had on hand $538,740.35 in net capital going into the USEG underwriting. Because $272,424.92 of that amount had to be retained to offset the firm's existing aggregate indebtedness, $266,315 in net capital was available to offset the indebtedness from the USEG underwriting. The parties also agree that the haircut set by the regulations for the USEG transaction was 30% of the market value of the offering – in this case, 30% of the $1.75 million, or $522,000. 17 C.F.R. § 240.15c3-1(c)(2)(vi)(J). The only disagreement comes over the final figure in the formula – the level of "unrealized profit" – and whether it was large enough to keep the transaction's net capital requirements below the $266,315 in excess net capital that Stuart-James had.

The parties present two alternative interpretations of the term "unrealized profit." The Commission and the NASD contend that the "unrealized profit" in this transaction is simply the 10% underwriter's concession, or $174,000, that Stuart-James would gain on the sale of the stock. Following the formula established in the regulations, they subtracted this $174,000 from the $522,000 haircut and calculated a net deduction from capital for the transaction of $348,000. Because the firm's excess net

capital at this time was only $266,315, the NASD and the Commission found that the firm had a net capital deficiency of $81,685 on November 2.

Stuart-James contends that its unrealized profit was larger than the Commission stated, and that when figured properly it was sufficiently large to keep the firm within the requirements of the net capital rule. Stuart-James makes three distinct criticisms of the approach to figuring net capital used by the Commission and the NASD. First, it uses a larger figure than the NASD and the Commission did for its concession on the securities sale. It notes that as it turned out, its actual concession was $30,000 larger than anticipated because there was a $300,000 overallotment on which it received a 10% concession. It therefore calculates that its actual concession was not $174,000 but $204,000. Stuart-James uses this larger figure in its capital calculations. Second, Stuart-James notes that the underwriting agreement called upon USEG to pay it in addition to the 10% underwriter's concession an unallocated expense allotment of not less than $120,000. It maintains that this unallocated expense allotment should count toward "unrealized profit" as well, since it could keep the allowance whether it spent it or not, and its actual underwriting expenses were only $19,000. Finally, the firm notes that the unallocated expense allotment, which was set at not less than $120,000, ended up actually being $138,000 in the final accounting between Stuart-James and USEG and that is the figure Stuart-James uses in its calculations.

Using these three modifications, Stuart-James calculated net profit in such a manner that it remained within the strictures of the net capital rule. It began, as did the

NASD and the Commission, with a haircut of $522,000. It then subtracted an "unrealized profit" of $342,000 – the $174,000 concession recognized by the Commission supplemented by the additional $30,000 traceable to the overallotment and the $138,000 unallocated expense allotment. Subtracted from the $522,000 haircut, the net profit deduction required for the transaction by this calculation is $180,000. Because it is agreed that Stuart-James had on hand $266,315 at the time of the transaction, Stuart-James contends that it never experienced a net capital deficiency.

Stuart-James's first modification, the additional $30,000 it added to the concession due to the overallotment, is not a large enough amount to affect whether or not the company violated the net capital rule. Nor does its third change, figuring the unallocated expense allotment at $138,000 rather than $120,000 make a significant difference. In neither case is the amount of money at issue large enough to affect whether or not Stuart-James had sufficient capital to be in conformity with the rule. The only material issue presented by the case is the propriety of Stuart-James's second modification, *i.e.* whether it may count the unallocated expense allotment as part of its unrealized profit at all. The Commission, in affirming the NADC's decision, held that it could not. We consider this question on this petition for review.

II. Discussion

The net capital rule states that "No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percent of his net capital." 17 C.F.R.

§ 240.15c3-1(a) (1987). If we accept the Commission's interpretation of the phrase "net capital," it is clear that the petitioners were in violation of the rule. Although the Commission's actions in this case were not ideal, we hold that petitioners were bound by the Commission's interpretation of the phrase.

We note at the outset that considerable deference is owed to an administrative agency's interpretation of regulations that it has promulgated under a statute that Congress has charged it with enforcing. The Supreme Court has instructed that "[i]n construing administrative regulations, 'the ultimate criterion is the administrative interpretation, which becomes the controlling weight unless it is plainly erroneous or inconsistent with the regulation.' " *United States v. Larinoff*, 431 U.S. 864, 872 (1977) (*quoting Bowles v. Seminole Rock Co.*, 325 U.S. 410, 414 (1945)). Agency interpretations are to be given particular deference when they "rest upon matters peculiarly within the administrator's field of expertise." *Southern Mutual Help Ass'n v. Califano*, 574 F.2d 518, 526 (D.C. Cir. 1977) (*quoting Thompson v. Clifford*, 408 F.2d 154, 167 (D.C. Cir. 1968)).

Evaluated under this most deferential standard, we are unable to say that the Commission's interpretation of the phrase "unrealized profit" was unreasonable. In interpreting the net capital rule, the Commission is charged with the paradoxical task of measuring something that does not yet exist: the "unrealized profit" on a transaction that has not yet occurred. Because it is not possible to know in advance what the dealer's profit will actually be, the rule makes it necessary for the Commission to anticipate the profit by relying on factors that can be

measured at the time. The Commission chose to do this by counting the firm's concession on the transaction as its net profit. This measure is necessarily only an approximation of actual profits, omitting several other factors that will in practice raise or lower the actual profits that a firm realizes on a transaction. For example, it does not include the sales commissions normally paid by a firm to its salesmen, which reduce the actual profit from a transaction below the amount of the concession. At the same time, it excludes from profits any unallocated expense allotment for a transaction, much of which might ultimately end up as profit for the firm. Still, we believe that the Commission's approach is a reasoanble one. Furthermore, there is no indication that the Commission has ever interpreted the phrase differently. Despite the necessary inexactitude, we are unable to find that the Commission abused its discretion in arriving at the interpretation it did.

Petitioners challenge their censure and fine on two additional and related grounds. They contend that the SEC's decision improperly relied upon a "secret" interpretation of its rule, *see* 5 U.S.C. § 553(b)(A), and that the Commission violated the Freedom of Information Act (FOIA) provisions of the APA, 5 U.S.C. § 552(a)(1), by failing to publish its interpretation of "unrealized profit." We do not agree with petitioners' contention that the SEC acted improperly by the standard of either § 552 or § 553 of the APA.

The rulemaking provision of the APA requires agencies to publish in advance only substantive rules. It expressly excludes from the publishing requirement "interpretive rules, general statements of policy, or rules

of agency organization, procedure, or practice." 5 U.S.C. § 553(b)(A). The interpretation at issue in the instant case clearly falls within this statutory rubric. It "only explain[ed] what the more general terms of the Act and regulations already provide." *Powderly v. Schweiker*, 704 F.2d 1092, 1098 (9th Cir. 1983). As such, it was not a substantive rule and the Commission was not legally obligated to publish it in advance.

The FOIA provisions of the APA by their own terms apply to "substantive rules of general applicability," "statements of general policy," and "interpretations of general applicability formulated and adopted by the agency." 5 U.S.C. § 552(a)(1)(D). The Commission's interretation of the phrase "unrealized profit" was none of these. We have noted above that the interpretaion was not a substantive rule. Neither was it a "statement of general policy" or an interpretation of "general applicability." An interpretation is not of "general applicability" if "(1) only a clarification or explanation of existing laws or regulations is expressed; and (2) no significant impact upon any segment of the public results." *Anderson v. Butz*, 550 F.2d 459, 463 (9th Cir. 1977) (citation omitted). The Commission's interpretation of the phrase merely explained an already existing regulation; it did not "adopt new rules or substantially modify existing rules, regulations, or statutes." *Lewis v. Weinberger*, 415 F. Supp. 652, 659 (D.N.M. 1976). As such the Commission was not required to publish it in advance.

Nevertheless, although we hold that the Commission did not abuse its discretion in interpreting the phrase "unrealized profit" for the first time at an adjudication, we do not mean to say that its timing in this regard was

ideal. The question of the precise meaning of this phrase is one that the Commission could and should have anticipated. To resolve it authoritatively for the first time in an adjudicatory proceeding in which a party is substantively and adversely affected is not a model of procedural fairness. *Cf. Nichols v. Brown*, 599 F.2d 639, 648 (5th Cir. 1979) ("[T]he application to a case of new principles announced in the course of deciding that case may be so tinged with unfairness as to amount to an abuse of administrative discretion.") But in any case, the petitioners were remiss in proceeding with the USEG underwriting without seeking a clarification of the meaning of the term and ensuring that they were in compliance with the net capital rule. This lapse, however, and the enforcement proceeding that ensued, did not call into question the integrity or character of the petitioners, as evidenced by the mild sanction imposed. Nevertheless, because we have found that the Commission's interpretation was a reasonable one, we affirm both its holding that petitioners violated the rule and the sanctions imposed.

The petition for review is

Denied.

APPENDIX B

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 87-1402 **September Term, 1988**

Stuart-James Company, Inc.
and Marc N. Geman,

Petitioners

v.

Securities and Exchange Commission,

Respondent

BEFORE: Mikva, D. H. Ginsburg, Circuit Judges and Jackson*, U.S. District Judge for the District of Columbia

ORDER
(Filed Nov. 17, 1988)

Upon consideration of petitioners' petition for rehearing filed November 4, 1988, it is

ORDERED, by the Court, that the petition is denied.

FOR THE COURT:

CONSTANCE L. DUPRE, CLERK

BY: /s/ Robert A. Bonner/CB
Robert A. Bonner
Deputy Clerk

*Sitting by designation pursuant to 28 U.S.C. § 292(a).

APPENDIX C

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 24590 / June 15, 1987

Admin. Proc. File No. 3-6668

In the Matter of the Application of

THE STUART-JAMES COMPANY, INC.
4601 DTC Boulevard
Denver, Colorado

and

MARC N. GEMAN

For Review of Disciplinary Action Taken by the

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - REVIEW OF DISCIPLINARY PROCEEDINGS

Violation of Rules of Fair Practice

Failure to Comply with Net Capital Requirements

Where member firm of registered securities association and its executive vice-president failed to comply with net capital requirements, *held*, association's findings of violation and the sanctions it imposed *affirmed*.

APPEARANCES:

Donald T. Trinen and *Christa D. Taylor*, of Hart & Trinen, for The Stuart-James Company, Inc. and Marc N. Geman.

Andrew McR. Barnes and *Jacqueline D. Whelan*, for the National Association of Securities Dealers, Inc.

I.

The Stuart-James Company, Inc., a member firm of the National Association of Securities Dealers ("NASD"), and Marc N. Geman, the firm's executive vice-president, appeal from disciplinary action taken against them by the NASD. The Association found that the firm violated net capital provisions, and that Geman was responsible for that violation. Accordingly, the NASD censured applicants and fined them $500, jointly and severally. Our decision is based on an independent review of the record.

II.

In 1984, the firm was principal underwriter of a $2 million public offering of the securities of U.S. Electronics Group, Inc. ("USEG") on a "firm commitment" basis. The NASD found that, as a result of its undertaking, the firm incurred a net capital deficiency on November 2, 1984.

In a "firm commitment" offering, the underwriter buys the securities from the issuer and assumes the risk of selling them. Once a broker-dealer commits itself to such an undertaking, it must immediately deduct a "haircut" from its net capital similar to the one required for securities held in inventory.[1] The haircut may be offset by any "unrealized profit" resulting from the commitment.[2]

---

[1] Rule 15c3-1(c)(2)(viii) under the Securities Exchange Act.

[2] *Id.*

In late October 1984, before the firm became legally bound to underwrite the USEG offering, it sought the NASD's approval of its proposed underwriting.[3] The NASD's staff expressed concern to Geman that the haircut on the offering might cause a net capital problem for his firm. Geman, the officer responsible for compliance with net capital requirements, accordingly agreed to allot about one-eighth of the offering to another dealer, and the NASD then gave its approval.

On November 1, the firm entered into a firm commitment underwriting agreement with USEG. Under the terms thereof, the firm agreed to purchase $1,740,000 worth of the $2 million offering in return for a concession of $174,000, a 10% discount from the offering price. USEG also agreed to give the firm an "unallocated expense reserve" of $120,000. The firm did not have to account to USEG for the actual expenses it paid from the reserve, and was permitted to keep any unexpended funds.

It is undisputed that the firm was required to take a $522,000 net capital haircut as a result of its open contractual commitment to USEG. The NASD allowed the firm to offset $174,000 against that haircut, the amount of the concession it was to receive. Even with the offset, however, the remaining $348,000 haircut caused a net capital deficiency of $81,684 on November 2.

Applicants contend that the expense reserve allotted the firm by USEG also constituted "unrealized profit" that

---

[3] Under an interpretation of the NASD's Board of Governors, the underwriting of certain offerings must be reviewed in advance by the NASD. NASD manual ¶ 2151, pp. 2019-2033.

should be offset against the haircut, erasing the net capital deficiency at issue. They argue that, from an accounting standpoint, the expense reserve is indistinguishable from the concession. They assert that both items constitute revenue to an underwriter; that expenses are incurred in connection with both; that neither item has a "set relationship" to those expenses; that the NASD did not deduct any expenses from the concession in computing unrealized profit; and that, on a percentage basis, the expense reserve is probably less subject to depletion by expenses than the concession. We find these arguments unpersuasive.

As noted above, when a broker-dealer undertakes a firm commitment underwriting, an immediate net capital haircut is required that can be offset by the unrealized profit arising from that commitment. It is true that the precise amount of that profit cannot be definitely ascertained at the time the underwriter makes his commitment. Nevertheless, at least in the common situation where the underwriter is separately reimbursed for many of its out-of-pocket expenses, it is reasonable to assume that the concession or discount an underwriter is slated to receive contains a substantial element of profit. Accordingly, the NASD and our staff have, as a matter of practice, consistently treated the entire amount of the underwriter's concession as unrealized profit in determining net capital.

The same assumption cannot be made for the expense reserve. Even though the reserve is "unallocated" (i.e., non-accountable), its purpose is to reimburse the underwriter for expenses incurred in connection with the underwriting. In fact, the USEG prospectus indicated that

the expense allowance at issue might not be sufficient to cover the firm's expenses. It stated:

> "[USEG] has agreed to pay [the firm] a nonaccountable expense allowance of $120,000 . . . . *The [firm's] expenses in excess of such amount will be borne by the [firm].* To the extent that the expenses of the [firm] are less than that amount, the excess shall be deemed to be additional compensation to the [firm]." (Emphasis added.)[4]

Applicants point to the Board of Governors' interpretation governing the NASD's review of corporate financing, which includes as items of underwriter's compensation both the amount of the underwriter's discount and all expenses payable by the issuer that would normally be paid by the underwriter.[5] However, the interpretation does not support applicants' position. While the issuer's payment of expenses normally borne by the underwriter may be considered "compensation" for purposes of the interpretation, such payment merely offsets the underwriter's costs, and thus does not constitute "profit" in the normal sense of that term.

Finally, applicants contend that, at best, the proper interpretation of the net capital provision at issue is uncertain and that, in a disciplinary proceeding such as this, doubts about the meaning of a rule should be resolved in the respondents' favor. This argument is wholly lacking in

---

[4] We take official notice of the prospectus, a copy of which is in our public official files. *See* Rule 14(d) of our Rules of Practice.

[5] NASD Manual ¶ 2151, p. 2031. *See* note 3, *supra*.

merit. Applicants did not rely on their current interpretation of the net capital rule in calculating the firm's net capital position on November 2, 1984, the date of the deficiency found by the NASD. In fact, Geman admitted at the NASD hearings that he had never heard of any firm deducting an expense allowance from a firm commitment haircut. In our view, the plain language of the rule contradicts applicants' interpretation and dictates the result we have reached.

We accordingly affirm the NASD's findings of violation.

III.

In view of the importance of our net capital rule as a safeguard for investors,[6] we are unable to conclude that the light sanctions assessed by the NASD are excessive or oppressive.

An appropriate order will issue.[7]

By the Commission (Commissioners COX, GRUNDFEST and FLEISCHMAN); Chairman SHAD and Commissioner PETERS not participating.

/s/ Jonathan G. Katz
Jonathan G. Katz
Secretary

---

[6] *See, e.g., Blaise D'Antoni & Associates, Inc. v. SEC*, 289 F.2d 276, 277 (5th Cir.), *cert. denied*, 368 U.S. 899 (1961).

[7] We have considered all of the contentions raised by applicants and the NASD. Their arguments are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 24590 / June 15, 1987

Admin. Proc. File No. 3-6668

In the Matter of the Application of

THE STUART-JAMES COMPANY, INC.
4601 DTC Boulevard
Denver, Colorado

and

MARC N. GEMAN

For Review of Disciplinary Action Taken by the

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

ORDER AFFIRMING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES ASSOCIATION

On the basis of the Commission's opinion issed this day, it is

ORDERED that the disciplinary action taken by the National Association of Securities Dealers, Inc. against The Stuart-James Company, Inc. and Marc N. Geman be, and it hereby is, affirmed.

By the Commission.

/s/ Jonathan G. Katz
Jonathan G. Katz
Secretary

APPENDIX D

Securities Exchange Act Section 15(c)(3), 15 U.S.C. 78*o*(c)(3)

(c) Use of manipulative or deceptive devices; contravention of rules and regulations

(3) No broker or dealer (other than a government securities broker or government securities dealer, except a registered broker or dealer) shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

Securities Exchange Act Rule 15c3-1, 17 C.F.R. 240.15c3-1

§ 240.15c3-1 Net capital requirements for brokers or dealers.

(a) No broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percentum of his net capital, except as otherwise limited by the provisions of paragraph (a)(1) of this section, or, in the case of a broker or dealer electing to operate pursuant to paragraph (f) of this section, no broker or dealer shall permit his net capital to be less than 2 percent of aggregate debit items as computed in accordance with § 240.15c3-3a of this chapter, or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, except as otherwise limited by paragraph (f) of this section, and every broker or dealer shall have the net capital necessary to comply with the following conditions, except as otherwise provided for in paragraph (f) of this section.

(1) *Brokers or Dealers Engaging in a General Securities Business.* No broker or dealer, except one who operates under paragraph (f) of this section, shall permit his aggregate indebtedness to all other persons to exceed 800 percentum of his net capital for 12 months after commencing business as a broker or dealer and, except as otherwise provided for in paragraph (a) or paragraph (f) of this section, the broker or dealer shall at all times have and maintain net capital of not less than $25,000 or $25,000 plus the sum of each broker or dealer subsidiary's minimum net capital requirement which is consolidated pursuant to Appendix (C) (17 CFR 240.15c3-1c).

(2) *Brokers Who Do Not Generally Carry Customers' Accounts.* Notwithstanding the provision of paragraph (a)(1) of this section, a broker or dealer shall have and maintain net capital of not less than $5,000 if he does not hold funds or secutities for, or owe money or securities to, customers and does not carry accounts of, or for, customers, except as provided for in paragraph (a)(2)(v) of this section, and he conducts his business in accordance with one or more of the following conditions and does not engage in any other securities activities;

(i) He introduces and forwards as a broker all transactions and accounts of customers to another broker or dealer who carries such accounts on a fully disclosed basis and (the introducing broker or dealer) promptly forwards all of the funds and securities of customers received in connection with his activities as a broker;

(ii) He participates, as broker or dealer, in underwritings on a "best efforts" or "all or none" basis in accordance with the provisions of 17 CFR 240.15c2-4(b)(2) and he promptly forwards to an independent escrow agent customers' checks, drafts, notes or other evidences of indebtedness received in connection therewith which shall be made payable to such escrow agent;

(iii) He promptly forwards, as broker or dealer, subscriptions for securities to the issuer, underwriter, sponsor or other distributor of such securities and receives checks, drafts, notes of other evidences of indebtedness payable solely to the issuer, underwriter, sponsor or other distributor who delivers the securities purchased directly to the subscriber;

(iv) He effects an occasional transaction in securities for his own investment account with or through another registered broker or dealer;

(v) He acts as broker or dealer with respect to the purchase, sale and redemption of redeemable shares of registered investment companies or of interests or participations in insurance company separate accounts, whether of not registered as an investment company, and he promptly transmits all funds and delivers all securities received in connection with such activities;

(vi) He introduces and forwards all customer and all principal transactions with customers to another broker or dealer who carries such accounts on a fully disclosed basis and promptly forwards all funds and securities received in connection with his activities as a broker or dealer and does not otherwise hold funds or securities for or owe money or securities to, customers and does not otherwise carry proprietary (except as provided in paragraph (a)(2)(iv) of this section) or customer accounts and his activities as dealer are limited to holding firm orders of customers and in connection therewith: (A) in the case of a buy order, prior to executing such customers' order, purchases as principle the same number of shares or purchases shares to accumulate the number of shares necessary to complete the order which shall be cleared through another broker or dealer or (B) in the case of a sell order, prior to executing such customers' orders, sells as principal the same number of shares of a portion thereof which shall be cleared through another broker or dealer; or

(vii) He effects, but does not clear, transactions in securities as a broker on a registered national securities exchange for the account of another member of such exchange.

(3) *Brokers or Dealers Engaged Solely in the Sale of Redeemable Shares of Registered Investment Companies and Certain Other Share Accounts.* Net capital of not less than $2,500 shall be maintained by a broker or dealer who engages in no other securities activities except those prescribed in this paragraph and who meets all of the following conditions:

(i) His dealer transactions are limited to the purchase, sale and redemption of redeemable shares of registered investment companies or of interests or participations in an insurance company separate account, except that he may also effect an occasional transaction in other securities for his own investment account with or through another registered broker or dealer;

(ii) His transactions as broker are limited to: (A) The sale and redemption of redeemable shares of registered investment companies or of interests or participations in an insurance company separate account whether or not registered as an investment company; (B) the solicitation of share accounts for savings and loan associations insured by an instrumentality of the United States; and, (C) the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies; and

(iii) He promptly transmits all funds and delivers all securities received in connection with his activities as a broker or dealer, and does not otherwise holds funds or

securities for, or owe money or securities for, of owe money or securities to, customers.

(4) *Certain Additional Capital Requirements for Market Makers.* Notwithstanding the provisions of paragraphs (a) (1), (2) and (3), a broker or dealer engaged in activities as a market maker as defined in paragraph (c)(8) of this section shall maintain net capital in an amount not less than $2,500 for each security in which he makes a market (unless a security in which he makes a market has a market value of $5 or less in which event the amount of net capital shall be not less than $500 for each such security) based on the average number of such markets made by such broker or dealer during the 30 days immediately preceding the computation date, except that under no circumstances shall he have net capital less than that required by paragraph (a)(1), or be required to maintain net capital of more than $100,000 unless otherwise required by the provisions of paragraphs (a) or (f) of this section.

(5) *Certain Additional Capital Requirements for Brokers or Dealers Engaged in the Sale of Options.* Notwithstanding the provisions of paragraphs (a) (1)-(4), a broker or dealer who endorses or writes options, including but not limited to puts, calls, straddles, strips, or straps otherwise than on a registered national securities exchange or a facility of a registered national securities association shall have net capital of not less than $50,000.

(6) *Market Makers, Specialists and certain Other Dealers.* (i) A dealer who meets the conditions of paragraph (a) (6)(ii) of this section may elect to operate under this paragraph (a)(6) and thereby not apply, except to the

extent required by this paragraph (a)(6), the provisions of paragraphs (c)(2)(vi), (f) (3) or Appendix A, 17 CFR 240.15c-3-1a, of this section to market maker and specialist transactions and, in lieu thereof, apply thereto the provisions of paragraph (a)(6)(iii) of this section.

(ii) This paragraph (a)(6) shall be available to a dealer who does not effect transactions with other than brokers or dealers, who does not carry customer accounts, who does not effect transactions in options not listed on a registered national securities exchange or facility of a registered national securities association, and whose market maker or specialist transactions are effected through and carried in a market maker or specialist account cleared by another broker or dealer as provided in paragraph (a)(6)(iv) of this section.

(iii) A dealer who elects to operate pursuant to this paragraph (a)(6) shall at all times maintain a liquidating equity in respect of securities positions in his market maker or specialist account at least equal to:

(A) An amount equal to 25 percent (5 percent in the case of exempted securities) of the market value of the long positions and 30 percent of the market value of the short positions; provided, however, in the case of long or short positions in options and long or short positions in securities other than options which relate to a bona fide hedged position as defined in paragraph (c)(2)(x)(C) of this section, such amount shall equal the deductions in respect of such positions specified by paragraph (c)(2)(x)(A) (*1*) through (*9*) of this section.

(B) Such lesser requirements as may be approved by the Commission under specified terms and conditions

upon written application of the dealer and the carrying broker or dealer.

(C) For purposes of this paragraph (a)(6)(iii), equity in such specialist or market maker account shall be computed by (*1*) marking all securities positions long or short in the account to their respective current market values, (2) adding (deducting in the case of a debit balance) the credit balance carried in such specialist or market maker account, and (3) adding (deducting in the case or short positions) the market value of positions) the market value of positions long in such account.

(iv) The dealer shall obtain from the broker or dealer carrying the market maker or specialist account a written undertaking which shall be designated "Notice Pursuant to § 240.15c3-1(a)(6) of Intention to Carry Specialist or Market Maker Account." Said undertaking shall contain the representations required by paragraph (a)(6) of this section and shall be filed with the Commission's Washington, D.C. Office, the regional office of the Commission for the region in which the broker or dealer has its principal place of business and the Designated Examining Authorities of both firms prior to effecting any transactions in said account. The broker or dealer carrying such account:

(A) Shall mark the account to the market not less than daily and shall issue appropriate calls for additional equity which shall be met by noon of the following business day;

(B) shall notify by telegraph the Commission and the Designated Examining Authorities pursuant to 17 CFR 240.17a-11, if the market maker of specialist fails to

deposit any required equity within the time prescribed in paragraph (a)(6)(iv)(A) above; said telegraphic notice shall be received by the commission and the Designated Examining Authorities not later than the close of business on the day said call is not met;

(C) Shall not extend further credit in the account if the equity in the account falls below that prescribed in paragraph (a)(6)(iii) of this section, and

(D) Shall take steps to liquidate promptly existing positions in the account in the event of a failure to meet a call for equity.

(v) No such carrying broker or dealer shall permit the sum of (A) the deductions required by paragraph (c)(2)(x)(A) of this section in respect of all transactions in market maker accounts guaranted indorsed or carried by such broker or dealer pursuant to paragraph (c)(2)(x) of this section and (B) the equity required by paragraph (iii) of this paragraph (a)(6) in respect of all transactions in the accounts of specialists of market makers in options carried by such broker or dealer pursuant to this paragraph (a)(6) to exceed 1,000 percent of such broker's or dealer's net capital as defined in paragraph (c)(2) of this section for any period exceeding five business days; *Provided,* That solely for purposes of this paragraph (a)(6)(v), deductions or equity required in a specialist or market maker account in respect of positions in fully paid securities (other than options), which do not underlie options listed on the national securities exchange or facility of a national securities association of which the specialist or market maker is a member, need not be recognized. *Provided further,* That if at any time such sum exceeds 1,000

percent of such broker's or dealer's net capital, then the broker or dealer shall immediately transmit telegraphic notice of such event to the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker or dealer maintains its principal place of business, and such broker's or dealer's Designated Examining Authority. *Provided further,* That if at any time such sum exceeds 1,000 percent of such broker's or dealer's net capital, then such broker or dealer shall be subject to the prohibitions against withdrawal of equity capital set forth in paragraph (e) of this section, and to the prohibitions against reduction, prepayment and repayment of subordination agreements set forth in paragraph (b)(11) of § 240.15c3-1d, as if such broker or dealer's net capital were below the minimum standards specified by each of the aforementioned paragraphs.

SELF-CLEARING OPTIONS SPECIALISTS

(7)(i) A dealer who meets the conditions of paragraph (ii) of this paragraph (a)(7) may elect to operate under this paragraph (a)(7) and thereby not apply, except to the extent required by this paragraph (a)(7), the provisions of paragraphs (c)(2)(vi),(c)(2)(x), (c)(2)(xi), and (f)(3) of this section or Appendix A (17 CFR 240.15c3-1a) to this section and, in lieu thereof, apply the provisions of paragraph (a)(7)(iii) of this section.

(ii) This paragraph (a)(7) shall be available to a broker or dealer engaged solely in one or more of the following activities:

(A) His transactions as a dealer are limited to the business of effecting (as sole proprietor or through one or more natural persons associated with such dealer ("associated specialist")) and clearing specialist or market maker transactions listed on a national securities exchange or a facility of a national securities association ("listed options"), or in the securities which underlie such options or which are exchangeable or convertible, without the payment of money, into such underlying securities ("underlying securities"); *Provided,* That such dealer may also guarantee, indorse or carry listed options and underlying securities purchased or sold by a specialist or market maker who is not associated with such dealer (an "independent specialist") and who either is not subject to the provisions of this § 240.15c3-1 or operates under paragraph (a)(6) of this section.

(B) His transactions as a broker are limited to (*1*) effecting transactions in securities as agent for an independent specialist whose market maker account such broker carries pursuant to the provisions of this section, and (2) effecting transactions on the floor of a national securities exchange in options or securities other than options listed on such an exchange as agent for another broker or dealer.

(iii) A dealer electing to operate pursuant to this paragraph (a)(7) shall adjust its net worth by deducting, for positions in each class of option contracts in which the dealer, as sole proprietor or through associated specialists, is a market maker ("proprietary positions"), or each such independent specialist is a market maker (and for positions in other securities), an amount equal to:

(A) The deductions specified by paragraph (c)(2)(x)(A) of his section; *Provided,* that for purposes of computing such deductions, proprietary positions, as well as positions in each such independent specialist's market maker account, shall be allocated in accordance with paragraph (c)(2)(x)(E) of this section; and, *Provided further,* That the deductions computed for each such independent specialist's positions pursuant to the foregoing shall be reduced by any liquidating equity as defined in paragraph (c)(2)(x)(B)(2) of this section, that exists in such independent specialist's market maker account, and shall be increased to the extent of any liquidating deficit in such account; and, *Provided further,* That in no event shall the foregoing proviso be construed to increase the net capital of any dealer electing to operate under this paragraph (a)(7).

(B) Such lesser requirement as may be approved by the commission under specified terms and conditions upon the written application of such dealer.

(iv) No dealer electing to operate under this paragraph (a)(7) shall permit the sum of the deductions required by paragraph (iii) of this paragraph (a)(7) in respect of all positions in the market maker accounts of independent specialists guaranteed, endorsed or carried by such dealer pursuant to this paragraph (a)(7), computed without regard to any liquidating equity or liquidating deficit in any such independent specialist's account, to exceed 1,000 percent of such dealer's net capital as defined in paragraph (c)(2) of this section for any period exceeding five business days; *Provided,* That

solely for purposes of this paragraph (a)(7)(iv), deductions required in the market maker account of an independent specialist in respect of positions in fully paid securities (other than options), which do not underlie options listed on the national securities exchanges or facility of a national securities association of which the independent specialist is a member, need not be recognized; *Provided further,* That if at any time such sum exceeds 1,000 percent of such dealer's net capital, then the dealer shall immediately transmit telegraphic notice of such event to the principal office of the commission in Washington, D.C., the regional office of the commission for the region in which the dealer maintains its principal place of business, and such dealer's Designated Examining Authority: *Provided further,* That if at any time such sum exceeds 1,000 percent of such dealer's net capital, then the dealer shall be subject to the prohibitions against withdrawal of equity capital set forth in paragraph (e) of this section, and to the prohibitions against reduction, prepayment of subordination agreements set forth in paragraph (b)(11) of § 240.15c3-1d, as if dealer's net capital were below the minimum standards specified by each of the aforementioned paragraphs.

(v) A dealer electing to operate under this paragraph (a)(7) shall comply in all respects with the requirements of paragraphs (c)(2)(x)(F) and (c)(2)(x)(G) of this section (or paragraph (a)(6)(iv) thereof insofar as such dealer acts as the guarantor, endorser or carrying dealer for options written or purchased by an independent specialist not subject to the provisions of this section (or operating pursuant to paragraph (a)(6) thereof).

(8) *Municipal Securities Broker's Brokers.* (i) A municipal securities brokers' brokers, as defined in subsection (ii) of this paragraph (a)(8), may elect not to be subject to the limitations of paragraph (c)(2)(ix) of this section provided that such brokers' broker complies with the requirements set out in parargraphs (iii), (iv) and (v) of this paragraph (a)(8).

(ii) The term municipal securities "broker's broker" shall mean a municipal securities broker or dealer who acts exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker or dealer or registered municipal securities dealer, who has no "cutsomers" as defined in this rule and who does not have or maintain any municipal securities in its proprietary or other accounts.

(iii) In order to qualify to operate under this paragraph (a)(8), a brokers' broker shall at all times have and maintain net capital of not less than $150,000.

(iv) For purposes of this paragraph (a)(8), a brokers' broker shall deduct from net worth 1% of the contract value of each municipal failed to deliver contract which is outstanding 21 business days or longer. Such deduction shall be increased by any excess of the contract price of the fail to deliver over the market value of the underlying security.

(v) For purposes of this paragraph (a)(8), a brokers' broker may exclude from its aggregate indebtedness computation indebtedness adequately collateralized by municipal securities outstanding for not more than one business day and offset by municipal securities failed to deliver of the same issue and quantity. In no event may a

broker's broker exclude any overnight bank loan attributable to the same municipal securities failed to deliver contract for more than one business day. A brokers' broker need not deduct from net worth the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of those failed to receive as required by Rule 15c3-1(c)(2)(iv)(E).

(b) Exemptions.

(1) The provisions of this section shall not apply to any specialist who does not transact a business in securities with other than members, brokers or dealers and who is in good standing and subject to the capital requirements of the American Stock Exchange (if he is not also a clearing member of the Options Clearing Corporation), the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Stock Exchange, the PBW Stock Exchange (if he is not also a clearing member of the Options Clearing corporation), or the Chicago Board Options Exchange (if he is not also a clearing member of the Options Clearing Corporation) provided that this exclusion as to a particular specialist of any exchange or as to the exchange itself may be suspended or withdrawn by the Commission at any time, upon ten (10) days written notice to such exchange or specialist, if it appears to the Commission that such action is necessary or appropriate in the public interest or for the protection of investors.

(2) A member in good standing of a national securities exchange who acts as a floor broker (and whose activities do not require compliance with other provisions

of this rule), may elect to comply, in lieu of the other provisions of this section, with the following financial responsibility standard: The value of the exchange membership of the member (based on the lesser of the most recent sale price or current bid price for an exchange membership) is not less than $15,000, or an amount equal to the excess of $15,000 over the value of the exchange membership is held by an independent agent in escrow: *Provided*, That the rules of such exchange require that the proceeds from the sale of the exchange membership of the member and the amount held in escrow pursuant to this paragraph shall be subject to the prior claims of the exchange and its clearing corporation and those arising directly from the closing out of contracts entered into on the floor of such exchanges.

(3) The Commission may, upon written application, exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any broker or dealer who satisifes the Commission that, because of the special nature of its business, its financial position, and the safeguards it has established for the protection of customers' funds and securities, it is not necessary in the public interest or for the protection of investors to subject the particular broker or dealer to the provisions of this section.

(c) Definitions. For the purpose of this section:

AGGREGATE INDEBTEDNESS

(1) The term "aggregate indebtedness" shall be deemed to mean the total money liabilities of a broker or

dealer arising in connection with any transaction whatsoever and includes, among other things, money borrowed, money payable against securities loaned and securities "failed to receive," the market value of securities borrowed to the extent to which no equivalent value is paid or credited (other than the market value of margin securities borrowed from customers in accordance with the provisions of 17 CFR 240.15c3-3 and margin securities borrowed from non-customers), customers' and non-customers' free credit balances, credit balances in customers' and non-customers' accounts having short positions in securities, equities in customers' and non-customers' future commodities accounts and credit balances in customers' and non-customers' commodities acounts, but excluding:

EXCLUSIONS FROM AGGREGATE INDEBTEDNESS

(i) Indebtedness adequately collateralized by securities which are carried long by the broker or dealer and which have not been sold or by securities which collateralize a secured demand note pursuant to Appendix (D) to this section 17 CFR 240.15c3-1d; indebtedness adequately collateralized by spot commodities which are carried long by the broker or dealer and which have not been sold; or, until October 1, 1976, indebtedness adequately collateralized by municipal securities outstanding for not more than one business day and offset by municipal securities failed to deliver of the same issue and quantity, where such indebtedness is incurred by a broker or dealer effecting transactions solely in municipal securities who is either registered with the Commission

or temporarily exempt from such registration pursuant to 17 CFR 240.15a-1(T) or 17 CFR 240.15Ba2-3(T);

(ii) Amounts payable against securities loaned, which securities are carried long by the broker or dealer and which have not been sold or which securities collateralize a secured demand note pursuant to Appendix (D) (17 CFR 240.15c)

(iii) Amounts payable against securities failed to receive which securities are carried long by the broker or dealer and which have not been sold or which securities collateralize a secured demand note pursuant to Appendix (D) (17 CFR 240.15c3-1d) or amounts payable against securities failed to receive for which the broker or dealer also has a receivable related to securities of the same issue and quantity thereof which are either fails to deliver or securities borrowed by the broker or dealer;

(iv) Credit balances in accounts representing amounts payable for securities or money market instruments not yet received from the issuer or its agent which securities are specified in paragraph (c)(2)(vi)(E) and which amounts are outstanding in such accounts not more than three (3) business days;

(v) Equities in customers' and non-customers' accounts segregated in accordance with the provisions of the Commodity Exchange Act and the rules and regulations thereunder;

(vi) Liability reseves established and maintained for refunds of charges required by section 27(d) of the Investment Company Act of 1940, but only to the extent of amounts on deposit in a segregated trust account in

accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940;

(vii) Amounts payable to the extent funds and qualified securities are required to be on deposit and are deposited in a "Special Reserve Bank Account for the Exclusive Benefit of Customers" pursuant to 17 CFR 240.15c3-3 under The Securities Exchange Act of 1934;

(viii) Fixed liabilities adequately secured by assets acquired for use in the ordinary course of the trade or business of a broker or dealer but no other fixed liabilities secured by assets of the broker or dealer shall be so excluded unless the sole recourse of the creditor for nonpayment of such liability is to such asset;

(ix) Liabilities on open contractual commitments;

(x) Indebtedness subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix (D) (17 CFR 240.15c3-1d);

(xi) Liabilities which are effectively subordinated to the claims of creditors (but which are not subject to a satisfactory subordination agreement as defined in Appendix (D) (17 CFR 240.15c3-1d)) by non-customers of the broker or dealer prior to such subordination, except such subordinations by customers as may be approved by the Examining Authority for such broker or dealer;

(xii) Credit balances in accounts of general partners; and

(xiii) Deferred tax liabilities.

NET CAPITAL

(2) The term "net capital" shall be deemed to mean the net worth of a broker or dealer, adjusted by:

(i) *Adjustments to net worth related to unrealized profit or loss and deferred tax provisions.* (A) Adding unrealized profits (or deducting unrealized losses) in the accounts of the broker or dealer;

(B)(*1*) In determining net worth, all long and all short positions in listed options shall be marked to their market value and all long and all short securities and commodities positions shall be marked to their market value.

(*2*) In determining net worth, the value attributed to any unlisted option shall be the difference between the option's exercise value and the market value of the underlying security. In the case of an unlisted call, if the market value of the underlying security is less than the exercise value of such call it shall be given no value and in the case of an unlisted put if the market value of the underlying security is more than the exercise value of the unlisted put it shall be given no value.

(C) Adding to net worth the lesser of any deferred income tax liability related to the items in (*1*), (*2*), and (3) below, or the sum of (*1*), (*2*) and (3) below;

(*1*) The aggregate amount resulting from applying to the amount of the deductions computed in accordance with paragraph (c)(2)(vi) and Appendices (A) and (B) (17 CFR 240.15c3-1a and 17 CFR 240.15c3-1b) or, where appropriate, paragraph (f) of this section, the appropriate

Federal and state tax rate(s) applicable to any unrealized gain on the asset on which the deduction was computed;

(2) Any deferred tax liability related to income accrued which is directly related to an asset otherwise deducted pursuant to this section;

(3) Any deferred tax liability related to unrealized appreciation in value of any asset(s) which has been otherwise deducted from net worth in accordance with the provisions of this section; and,

(D) Adding, in the case of future income tax benefits arising as a result of unrealized losses, the amount of such benefits not to exceed the amount of income tax liabilities accrued on the books and records of the broker or dealer, but only to the extent such benefits could have been applied to reduce accrued tax liabilities on the date of the capital computation, had the related unrealized losses been realized on that date.

(E) Adding to net worth any actual tax liabilities related to income accrued which is directly related to an asset otherwise deducted pursuant to this section.

(ii) *Subordinated Liabilities.* Excluding liabilities of the broker or dealer which are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix (D) (17 CFR 240.15c3-1d).

(iii) *Sole Proprietors.* Deducting, in the case of a broker or dealer who is a sole proprietor, the excess of liabilities which have not been incurred in the course of business as a broker or dealer over assets not used in the business.

(iv) *Assets Not Readily Convertible Into Cash.* Deducting fixed assets and assets which cannot be readily converted into cash (less any indebtedness excluded in accordance with subdivision (c)(1)(viii) of this section) including, among other things:

(A) *Fixed Assets and Prepaid Items.* Real estate; furniture and fixtures; exchange memberships; prepaid rent, insurance and other expenses; goodwill, organization expenses;

(B) *Certain unsecured and partly secured receivables.* All unsecured advances and loans; deficits in customers' and non-customers' unsecured and partly secured notes; deficits in special omnibus accounts maintained in compliance with the requirements of 12 CFR 220.4(b) of Regulation T under the Securities Exchange Act of 1934, or similar accounts carried on behalf of another broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less; deficits in customers' and non-customers' unsecured and partly secured accounts after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less, except deficits in cash accounts as defined in 12 CFR 220.4(c) of Regulation T under the Securities Exchange Act of 1934 for which not more than one extention respecting a specified securities transaction has been requested and granted, and deducting for securities carried in any of such accounts the percentages specified in paragraphs (c)(2)(vi) or (f) of this section or Appendix A (17 CFR 240.15c3-1a); the market value of stock loaned in excess of the value of any collateral received therefore; receivables arising out of free shipments of securities

(other than mutual fund redemptions) in excess of $5,000 per shipment and all free shipments (other than mutual fund redemptions) outstanding more than 7 business days, and mutual fund redemptions outstanding more than 16 business days; any collateral deficiencies in secured demand notes as defined in Appendix D (17 CFR 240.15c3-1d);

(C) Interest receivable, floor brokerage receivable, commissions receivable from other brokers or dealers (other than syndicate profits which shall be treated as required in paragraph (c)(2)(iv)(E) of this section), mutual fund concessions receivable and management fees receivable from registered investment companies, all of which receivables are outstanding longer than thirty (30) days from the date they arise; dividends receivable outstanding longer than thirty (30) days from the payable date; good faith deposits arising in connection with a non-municipal securities underwriting, outstanding longer than eleven (11) business days from the settlement of the underwriting with the issuer; receivables due from participation in municipal securities underwriting syndicates and municipal securities joint underwriting accounts which are outstanding longer than sixty (60) days from settlement of the underwriting with the issuer and good faith deposits arising in connection with an underwriting of municipal securities, outstanding longer than sixty (60) days from settlement of the underwriting with the issuer; and receivables due from participation in municipal securities secondary trading joint accounts, which are outstanding longer than sixty (60) days from the date all securities have been delivered by the account manager to the account members;

(D) *Insurance Claims.* Insurance claims which, after seven (7) business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims which after twenty (20) business days from the date the loss giving rise to the claim is discovered and which are accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier; and,

(E) *Other Deductions.* All other unsecured receivables; all assets doubtful of collection less any reserves established therefore; the amount by which the market value of securities failed to receive outstanding longer than thirty (30) calendar days exceeds the contract value of such fails to receive, and the funds on deposit in a "segregated trust account" in accordance with 17 CFR 270.27d-1 under the Investment Company Act of 1940, but only to the extent that the amount on deposit in such segregated trust account exceeds the amount of liability reserves established and maintained for refunds of charges required by sections 27(d) and 27(f) of the Investment Company Act of 1940; *Provided,* That any amount deposited in the "Special Reserve Bank Account for the Exclusive Benefit of Customers" established pursuant to 17 CFR 240.15c3-3 and clearing deposits shall not be so deducted.

(F)(*1*) For purposes of this paragraph:

(*i*) The term "repurchase agreement" shall mean an agreement to sell securities subject to a commitment to repurchase from the same person securities of the same quantity, issuer and maturity;

(*ii*) The term "reverse-repurchase agreement" shall mean an agreement to purchase securities subject to a commitment to resell to the same person securities of the same quantity, issuer and maturity; and

(2)(*i*) In the case of a reverse-repurchase agreement, the deduction shall be equal to a percentage of the difference between the contract price for resale of the securities under a reverse-repurchase agreement and the market value of those securities (if less than the contract price), determined on the basis of the date to maturity of the reverse-repurchase agreement, as of the net capital computation date, as follows:

(*A*) 7 days or less: 0 percent.

(*B*) 8 days to 14 days: 5 percent.

(*C*) 15 days to 30 days: 10 percent.

(*D*) 31 days to 60 days: 25 percent.

(*E*) 61 days to 90 days: 50 percent.

(*F*) 91 days or more: 100 percent.

(*ii*) If the market value of the securities subject to the reverse-repurchase agreement declines to below 50 percent of the contract price for resale under that agreement, the applicable deduction shall equal 100 percent of the difference between the contract price for resale of the securities under the agreement and the market value of those securities.

(*iii*) A deduction on account of reverse-repurchase agreement may be offset by any margin or other deposits held by the broker or dealer on account of the reverse-repurchase agreement or by any excess market value of the securities over the contract price for the resale of those securities under any other reverse-repurchase agreement with the same person.

(*iv*) A broker or dealer shall deduct an amount equal to the excess of the difference between the contract prices for resale of the securities under reverse-repurchase agreements and the market value of the securities (if less than the contract prices) in any single account (or related accounts) if in the aggregate the differences exceed 5 percent of net capital before the application of paragraph (c)(2)(vi), or (f)(3) of this section, or Appendix A to 17 CFR 240 15c3-1.

(*v*) The required deduction under this subsection (2) shall not exceed 100 percent of the difference between the contract price for resale of the securities and the market value of those securities.

(G) *Securities borrowed.* 1 percent of the market value of securities borrowed collateralized by an irrevocable letter of credit.

(v)(A) Deducting the market value of all short securities differences (which shall include securities positions reflected on the securities record which are not susceptible to either count or confirmation) unresolved after discovery in accordance with the following schedule:

Differences[1]	Numbers of business days after discovery
25 percent	7
50 percent	14
75 percent	21
100 percent	28

(B) Deducting the market value of any long securities differences, where such securities have been sold by the broker or dealer before they are adequately resolved, less any reserves established therefore;

(C) The designated examining authority for a broker or dealer may extend the periods in (A) above for up to 10 business days if it finds that exceptional circumstances warrant an extension.

(vi) *Securities Haircuts.* Deducting the percentages specified in paragraphs (A)-(M) below (or the deductions prescribed for securities positions set forth in appendix (A) (17 CFR 240.15c3-1a) or, where appropriate, paragraph (f) of this section) of the market value of all securities, money market instruments or options in the proprietary or other accounts of the broker or dealer.

(A)(*1*) In the case of a security issued or guaranteed as to principal or interest by the United States or any

[1] Percentage of market value of short securities differences.

agency thereof, the applicable percentages of the market value of the net long or short position in each of the categories specified below are:

CATEGORY 1

(*i*) Less than 3 months to maturity – 0 percent.

(*ii*) 3 months but less than 6 months to maturity – 1/2 of 1 percent.

(*iii*) 6 months but less than 9 months to maturity – 3/4 of 1 percent.

(*iv*) 9 months but less that 12 months to maturity – 1 percent.

CATEGORY 2

(*i*) 1 year but less than 2 years to maturity – 1 1/2 percent.

(*ii*) 2 years but less than 3 years to maturity – 2 percent.

CATEGORY 3

(*i*) 3 years but less than 5 years to maturity – 3%.

(*ii*) 5 years but less than 10 years to maturity – 4%.

CATEGORY 4

(*i*) 10 years but less than 15 years to maturity – 4 1/2%.

(*ii*) 15 years but less than 20 years to maturity – 5%.

(*iii*) 20 years but less than 25 years to maturity – 5 1/2%.

(*iv*) 25 years or more to maturity – 6%.

Brokers or dealers shall compute a deduction for each category above as follows: Compute the deductions for the net long or short positions in each subcategory above. The deduction for the category shall be the net of the aggregate deductions on the long positions and the aggregate deductions on the short positions in each category plus 50% of the lesser of the aggregate deductions on the long or short positions.

(2) A broker or dealer may elect to deduct, in lieu of the computation required under paragraph (c)(2)(vi)(A)(*1*) of this section, the applicable percentages of the market value of the net long or short positions in each of the subcategories specified in paragraph (c)(2)(vi)(A)(*1*) of this section.

(3) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may elect to exclude the market value of a long or short security from one category and a security from another category, *Provided,* That:

(*i*) Such securities have maturity dates:

(*A*) Between 9 months and 15 months and within 3 months of one another.

(*B*) Between 2 years and 4 years and within 1 year of one another; or

(*C*) Between 8 years and 12 years and within 2 years of one another.

(*ii*) The net market value of the two excluded securities shall remain in the category of the security with the higher market value.

(*4*) In computing deductions under paragraph (c)(2)(vi)(A)(*1*) of this section, a broker or dealer may include in the categories specified in paragraph (c)(2)(vi)(A)(*1*) of this section, long or short positions in securities issued by the Untied States or any agency thereof that are deliverable against long or short positions in futures contracts relating to Government securities, traded on a recognized contract market approved by the Commodity Futures Trading Commission, which are held in the proprietary or other accounts of the broker or dealer. The value of the long or short positions included in the categories shall be determined by the contract value of the futures contract held in the account. The provisions of Appendix B to Rule 15c3-1 (17 CFR 240.15c3-1b) will in any event apply to the positions in futures contracts.

(*5*) In the case of a Government securities dealer which reports to the Federal Reserve System, which transacts business directly with the Federal Reserve System, and which maintains at all times a minimum net capital of at least $50,000,000 before application of the deductions provided for in paragraph (c)(2)(vi) or (f)(3) of this section, the deduction for a security issued or guaranteed as to principal or interest by the United States or any agency thereof shall be 75% of the deduction otherwise computed under subparagraph (c)(2)(vi)(A).

(B)(*1*) In the case of any municipal security which has a scheduled maturity at date of issue of 731 days or less and which is issued at par value and pays interest at

maturity, or which is issued at a discount, and which is not traded flat or in default as to principal or interest, the applicable percentages of the market value on the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 30 days to maturity – 0%.

(*ii*) 30 days but less than 91 days to maturity – 1/8 of 1%.

(*iii*) 91 days but less than 181 days to maturity – 1/4 of 1%.

(*iv*) 181 days but less than 271 days to maturity – 3/8 of 1%.

(*v*) 271 days but less than 366 days to maturity – 1/2 of 1%.

(*vi*) 366 days but less than 456 days to maturity – 3/4 of 1%.

(*vii*) 456 days but less than 732 days to maturity – 1%.

(2) In the case of any municipal security, other than those specified in paragraph (c)(2)(vi)(B)(*1*), which is not traded flat or in default as to principal or interest, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity – 1%.

(*ii*) 1 year but less than 2 years to maturity – 2%.

(*iii*) 2 years but less than 3 1/2 years to maturity – 3%.

(*iv*) 3 1/2 years but less than 5 years to maturity – 4%.

(*v*) 5 years but less than 7 years to maturity – 5%.

(*vi*) 7 years but less than 10 years to maturity – 5 1/2%.

(*vii*) 10 years but less than 15 years to maturity – 6%.

(*viii*) 15 years but less than 20 years to maturity – 6 1/2%.

(*ix*) 20 years or more to maturity – 7%.

(C) *Canadian Debt Obligations*. In the case of any security issued or unconditionally guaranteed as to principal and interest by the Government of Canada, the percentages of market value to be deducted shall be the same as in paragraph (A) of this section.

(D)(1) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is generally known as a "money market fund," the deduction shall be 2% of the market value of the greater of the long or short position.

(2) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which are described in paragraph (c)(2)(vi) (A) through (C) or (E) of this section, the deduction shall be 7% of the market value of the greater of the long or short positions.

(3) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi) (A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

(E) *Commercial paper, bankers acceptances and certificates of deposit.* In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, and which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations (*Provided*, That effective January 1, 1977, and until September 1, 1977, this paragraph shall be deemed to require only one such rating), or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:

(*1*) Less than 30 days to maturity – 0 percent.

(2) 30 days but less than 91 days to maturity 1/8 of 1 percent.

(3) 91 days but less than 181 days to maturity 1/4 of 1 percent.

(4) 181 days but less than 271 days to maturity 3/8 of 1 percent.

(5) 271 days but less than 1 year to maturity 1/2 of 1 percent; and

(6) With respect to any negotiable certificate of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank, as defined above, having 1 year or more to maturity, the deduction shall be on the greater of the long or short position and shall be the same percentage as that prescribed in paragraph (c)(2)(vi)(A) of this section.

(F)(1) In the case of nonconvertible debt securities having a fixed interest rate and fixed maturity date and which are not traded flat or in default as to principal or interest and which are rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, the applicable percentages of the market value of the greater of the long or short position in each of the categories specified below are:

(*i*) Less than 1 year to maturity – 2%.

(*ii*) 1 year but less than 2 years to maturity – 3%.

(*iii*) 2 years but less than 3 years to maturity – 5%.

(*iv*) 3 years but less than 4 years to maturity – 6%.

(*v*) 4 years but less than 5 years to maturity – 7%.

(*vi*) 5 years or more to maturity – 9%.

(2) A broker or dealer may elect to exclude from the above categories long or short positions that are hedged

with short or long positions in securities issued by the United States or any agency thereof and that have maturity dates of within – 3 months, if the nonconvertible debt security has a maturity date of less than 15 months; 6 months, if the nonconvertible debt security has a maturity date of greater than 15 months but less than 2 years; 1 year, if the nonconvertible debt security has a maturity date of greater than 2 years but less than 5 years; and 5 years, if the nonconvertible debt security has a maturity of 5 years or more. The electing broker or dealer shall also exclude the hedging short or long securities position from the applicable haircut category under paragraph (c)(2)(vi)(A) of Rule 15c3-1 (240.15c3-1(c)(2)(vi)(A)), but shall deduct a percentage of the market value of the hedged long or short position in nonconvertible debt securities as specified in each of the categories below:

(*i*) Less than 1 year to maturity – 1%.

(*ii*) 1 year but less than 2 years to maturity – 1 1/2%.

(*iii*) 2 years but less than 3 years to maturity – 2 1/2%.

(*iv*) 3 years but less than 4 years to maturity – 3%.

(*v*) 4 years but less than 5 years to maturity – 3 1/2%.

(*vi*) 5 years or more to maturity – 4 1/2%.

(g) *Convertible Debt Securities.* In the case of a debt security not in default which has a fixed rate of interest and a fixed maturity date and which is convertible into an equity security, the deductions shall be as follows: If the market value is 100 percent or more of the principal

amount, the deduction shall be determined as specified in paragraph (c)(2)(vi)(J) of this section; if the market value is less than the principal amount, the deduction shall be determined as specified in paragraph (F) of this section; if such securities are rated as required of paragraph (F) of this section;

(H) In the case of cumulative, nonconvertible preferred stock ranking prior to all other classes of stock of the same issuer, which is rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations and which are not in arrears as to dividends, the deduction shall be 10% of the market value of the greater of the long or short position.

(I) *Risk Arbitrage Positions.* In the case of each risk arbitrage transaction, the deduction shall be 30 percent (or such other percentage as required by this subdivision) on the long or equivalent short position, whichever has the greater market value. For the purposes of this paragraph (I), a "risk arbitrage transaction" shall mean the sale (either when issued, when distributed of short) of securities involved in a pending merger, consolidation, transfer of assets, exchange offer, recapitalization or other similar transaction which has been publicly announced and has not been terminated, in connection with a previous or approximately simultaneous offsetting purchase of other securities which upon consummation of the transaction will result in the equivalent of the securities sold.

(J) *All Other Securities.* In the case of all securities or evidence of indebtedness, except those described in

Appendix (A), 17 CFR 240.15c3-1a and where appropriate, paragraph (f) of this section, which are not included in any of the percentage categories enumerated in paragraphs (c)(2)(vi)(A) through (I) of this section or (K)(*ii*) of this section, the deduction shall be 30 percent of the market value or the greater of the long or short positions and to the extent the market value of the lesser of the long or short positions exceeds 25 percent of the market value of the greater of the long or short position, there shall be a percentage deduction on such excess equal to 15 percent of the market value of such excess. *Provided,* That no deduction need be made in the case of (*1*) a security which is convertible into or exchangeable for other securities within a period of 90 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible or for which it is exchangeable, are short in the accounts of such broker or dealer or (2) a security which has been called for redemption and which is redeemable within 90 days.

(K) *Securities with a Limited Market.* In the case of securities (other than exempted securities, nonconvertible debt securities, and cumulative nonconvertible perferred stock) which are not: (*1*) Traded on a national securities exchange; (2) designated as "OTC Margin Stock" pursuant to Regulation T under the Securities Exchange Act of 1934; (*3*) quoted on "NASDAQ"; or (*4*) redeemable shares of investment companies registered under the Investment Company Act of 1940, the deduction shall be as follows:

(*i*) In the case where there are regular quotations in an inter-dealer quotations system for the securities by

three or more independent market-makers (exclusive of the computing broker or dealer) and where each such quotation represents a bona fide offer to brokers or dealers to both buy and sell in reasonable quantities at stated prices, or where a ready market as defined in paragraph (c)(11) (ii) is deemed to exist, the deduction shall be determined in accordance with paragraph (c)(2)(vi)(J) of this section;

(*ii*) In the case where there are regular quotations in an inter-dealer quotations system for the securities by only one or two independent marketmakers (exclusive of the computing broker or dealer) and where each such quotation represents a bona fide offer to brokers or dealers both to buy and sell in reasonable quantities, at stated prices, the deduction on both the long and short position shall be 40 percent.

(L) Where a broker or dealer demonstrates that there is sufficient liquidity for any securities long or short in the proprietary or other accounts of the broker or dealer which are subject to a deduction required by paragraph (c)(2)(vi)(K) of this section, such deduction, upon a proper showing to the Examining Authority for the broker or dealer, may be appropriately decreased, but in no case shall such deduction be less than that prescribed in paragraph (c)(2)(vi)(J) of this section.

(M) *Undue Concentration.* In the case of money market instruments or securities of a single class or series of an insurer, including any option written, endorsed or held to purchase or sell securities of such a single class of series of an insurer (other than "exempted securities" and

redeemable securities of an investment company registered pursuant to the Investment Company Act of 1940), which are long or short in the proprietary or other accounts of a broker or dealer, including securities which are collateral to secured demand notes defined in Appendix (D) (17 CFR 240.15c3-1d), for more than 11 business days and which have a market value of more than 10 percent of the "net capital" of a broker or dealer before the application of subparagraph (c)(2)(vi) of this section or Appendix (A) (17 CFR 240.15c3-1a), there shall be an additional deduction from net worth and/or the Collateral Value for securities collateralizing a secured demand note defined in Appendix (D) (17 CFR 240.15c3-1d), equal to 50 percent of the percentage deduction otherwise provided by this paragraph (c)(2)(vi) of this section or Appendix (A) (17 CFR 240.15c3-1a), on that portion of the securities position in excess of 10% of the "net capital" of the broker or dealer before the application of paragraph (c)(2)(vi) of this section and Appendix (A) (17 CFR 240.15c3-1a).

This provision shall apply notwithstanding any long or short position exemption provided for in paragraph (c)(2)(vi)(I) or (J) of this section (except for long or short position exemptions arising out of the proviso to paragraph(c)(2)(vi)(J) of this section) and the deduction on any such exempted position shall be 15% of that portion of the securities position in excess of 10% of net capital before the application of paragraph (c)(2)(vi) of this section and Appendix (a) (17 CFR 240.15c3-1a). *Provided*, That such additional deduction shall be appplied in the case of equity securities only on the market value in excess of $10,000 or the market value of 500 shares,

whichever is greater, or $25,000 in the case of a debt security. *Provided, further,* That any specialist which is subject to a deduction required by this paragraph (c)(2)(vi)+(M), respecting his specialty stock, who can demonstrate to the satisfaction of the Examining Authority for such broker or dealer that there is sufficient liquidity for such specialists' specialty stock and that such deduction need not be applied in the public interest for the protection of investors, may upon a proper showing to such Examining Authority have such undue concentration deduction appropriately decreased, but in no case shall the deduction prescribed in paragraph (c)(2)(vi)(J) of this section be reduced. Each such Examining Authority shall make and preserve for a period of not less than 3 years a record of each application granted pursuant to this subdivision, which shall contain a summary of the justification for the granting of the application. *Provided further,* This provision will be applied to an issue of municipal securities having the same security provisions, date of issue, interest rate, day, month and year of maturity only if such securities have a market value in excess of $500,000 in bonds ($5,000,000 in notes) or 10% of tentative net capital, whichever is greater, and are held in position longer than twenty (20) business days from the date the securities are received by the syndicate manager from the issuer.

(vii) *Non-Marketable Securities.* Deducting 100 percent of the carrying value in the case of securities or evidence of indebtedness in the proprietary or other accounts of the broker or dealer, for which there is no ready market, as defined in paragraph (c)(11) of this section, and securities, in the proprietary of other

accounts of the broker or dealer, which cannot be publicly offered of sold because of statutory, regulatory or contractual arrangements or other restrictions.

(viii) *Open Contractual Commitments.* Deducting, in the case of a broker or dealer who has open contractual commitments (other than those option positions subject to Appendix (A) (17 CFR 240.15c3-1a)) the respective deductions as specified in paragraph (c)(2)(vi) of this section or Appendix (B) (17 CFR 240.15c3-1b) from the value (which shall be the market value whenever there is a market) of each net long and each net short position contemplated by any open contractual commitment in the proprietary or other accounts of the broker or dealer. In the case of a broker or dealer electing to operate pursuant to paragraph (f) of this section, the percentage deduction for contractual commitments in those securities which are treated in subdivision (f)(3)(ii) of this section shall be 30%. Provided, that the deduction with respect to any single commitment shall be reduced by the unrealized profit, in an amount not greater than the deduction provided for by this section (or increased by the unrealized loss), in such commitment, and that in no event shall an unrealized profit on any closed transactions operate to increase net capital.

(ix) Deducting from the contract value of each failed to deliver contract which is outstanding 5 business days or longer (21 business days or longer in the case of municipal securities) the percentages of the market value of the underlying security which would be required by application of the deduction required by paragraph (c)(2)(vi) or, where appropriate, paragraph (f) of this section. Such deduction, however, shall be increased by any

excess of the contract price of the failed to deliver contract over the market value of the underlying security or reduced by any excess of the market value of the underlying security over the contract value of the fail but not to exceed the amount of such deduction; *Provided*, however, That until January 1, 1983, the deduction provided for herein shall be applied only to those fail to deliver contracts which are outstanding 7 business days or longer (21 business days or longer in the case of municipal securities). The designated examining authority for the broker or dealer may, upon application by the broker or dealer, extend for a period of up to 5 business days, any period herein specified where it is satisfied that the extension is warranted. The designated examining authority upon expiration of the extension may extend for one additional period of up to 5 business days, any period herein specified when it is satisfied that the extension is warranted.

(x) *Brokers or Dealers Carrying Accounts of Options Specialists*. (A) With respect to any transaction in options listed on a registered national securities exchange or a facility of a registered national securities association for which a broker or dealer acts as a guarantor, endorser or carrying broker or dealer for opinions purchased or written by a specialist not otherwise subject to the provisions of this section, such broker or dealer shall adjust its net worth by deducting, for each class of option contracts in which each such specialist is a market maker, an amount equal to 50 percent of the market value of each option contract in a long position and 75 percent of the market value of each contract in a short position; provided, however, that:

(1) For the purpose of the above deductions, each option contract in a short position shall be deemed to have a market value of not less than $100.

(2) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x) involving a long position in a security, other than an option, and a short position in a call option, the deduction shall be 30 percent (or such other percentage required by paragraphs (c)(2)(vi)(A)-(K) of this section or 15 percent if such broker or dealer operates pursuant to paragraph (f) of this section) of the market value of the long position reduced by any excess of the market value of the long position over the exercise value of the short option position; provided, that no such reduction shall operate to increase net capital.

(3) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x) involving a short position in a security, other than an option, and a long position in a call option, the deduction shall be the lesser of 30 percent of the market value of the short position or the amount by which the exercise value of the long option position exceeds the market value of the short position; however, if the exercise value of the long option position does not exceed the market value of the short position, no deduction shall be applied.

(4) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x) involving a short position in a security, other than an option, and a short position in a put option, the deduction shall be 30 percent (or such other percentage required by paragraphs (A) through (K) of paragraph (c)(2)(vi) of this section) of the

market value of the short security position reduced by any excess of the exercise value of the short option position over the market value of the short security position; provided, that no such reduction shall operate to increase net capital.

(5) In the case of a bona fide hedged position as defined in this paragraph (c)(2)(x) involving a long position in a security, other than an option, and a long position in a put option, the deduction shall be the lesser of 30 percent (15 percent if such broker or dealer operates pursuant to paragraph (f) of this section) of the market value of such long security position or the amount by which the market value of such long security position exceeds the exercise value of the long option position; however, if the market value of the long security position does not exceed the exercise value of the long option position, no deduction shall be applied.

(6) In the case of a bona fide spread position as defined in this paragraph (c)(2)(x) in which the market value of the long position exceeds the market value of the short position, the deduction shall be 50 percent of the greater of the difference between the market values of such long and short positions or $50 for each option contract included in the long position as part of such spread position; provided, that such endorser, guarantor or carrying broker or dealer need not deduct more in respect of any such spread position in a particular underlying security and in respect of option contracts for the same underlying security which are carried in a pure short position in such specialist's market maker account

than the greater of the deduction required by this paragraph (6) in respect of the spread position or the deduction required by paragraphs (A) and (A)(1) of this paragraph (c)(2)(x) in respect of the pure short position.

(7) In the case of a bona fide spread position as defined in this paragraph (c)(2)(x) in which the market value of the short position equals or exceeds the market value of the long position, the deduction shall be 75 percent of the greater of the difference between the market values of such short and long positions or $50 for each option contract included in the long position as part of such spread position; provided, that if the option contracts in the short position expire no later than the option contracts in the long position, such deduction need not exceed the greater of 75 percent of $50 per long contract, or the amount by which the difference between the market values of the short and long positions is less than the amount by which the exercise value of the long position exceeds the exercise value of the short position; and *Provided further,* That such endorser, guarantor or carrying broker or dealer need not deduct more in respect of any such spread position in a particular underlying security and in respect of option contracts for the same underlying security which are carried in a pure long position in such specialist's market maker account than the greater of the deduction required by this paragraph (7) in respect of the spread position or the deduction required by paragraph (A) of this paragraph (c)(2)(x) in respect of the pure long position.

(8) In the case of a bona-fide straddle position as defined in this paragraph (c)(2)(x), the deduction shall be the greater of the deductions which this paragraph

(c)(2)(x) would require in respect of the call option position and the put option if both positions were pure long (or short) positions.

(9) In the case of positions in securities which are not part of a bona fide hedged spread or straddle position as defined in this paragraph (c)(2)(x) and, in the case of options, which are not listed on the national securities exchange of a national securities association of which such specialist is a member, the deduction shall be that set forth in paragraph (c)(2)(vi) of this section, or, if such securities are options, the deduction shall be that set forth in Appendix A (17 CFR 240.15c3-1a) to this section.

(B) The deduction computed for each specialist's positions pursuant to paragraph (A) of this paragraph (c)(2)(x) shall be reduced by any liquidating equity, as defined in this paragraph (c)(2)(x), that exists in such specialist's market maker account with the broker or dealer, and shall be increased to the extent of any liquidating deficit in such account. Provided, that in no event shall this provision result in increasing the net capital of any such guarantor, endorser, or carrying broker or dealer.

(*1*) No such guarantor, endorser or carrying broker or dealer shall permit the sum of (*i*) the deductions required by paragraph (A) of this paragraph (c)(2)(x) in respect of all transactions in specialists' market maker accounts guaranteed, endorsed or carried by such broker or dealer and (*ii*) the equity required by paragraph (a)(6)(iii) of this section in respect of all transactions in the accounts of specialists or market makers in options carried by such broker or dealer pursuant to paragraph

(a)(6) of this section to exceed 1000 percent of such broker's or dealer's net capital as defined in paragraph (c)(2) of this section for any period exceeding five business days; *Provided,* That solely for purposes of this paragraph (c)(2)(x)(B)(*1*), the deductions or equity required in a specialist's or market maker's account in respect of positions in fully paid securities (other than options), which do not underlie options listed on the national securities exchange or facility of a national securities association of which such specialist or market maker is a member, need not be recognized; *Provided further,* That if at any time such sum exceeds 1000 percent of such broker's or dealer's net capital, then the broker or dealer shall immediately transmit telegraphic notice of such event to the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker or dealer maintains its principal place of business, and such broker's or dealer's Designated Examining Authority; *Provided further,* That if at any time such sum exceeds 1000 percent of such broker's or dealer's net capital, then such broker or dealer shall be subject to the prohibitions against withdrawal of equity capital set forth in paragraph (e) of this section, and to the prohibitions against reduction, prepayment and repayment of subordination agreements set forth in paragraph (b)(11) of this § 240.15c3-1d, as if such broker or dealer's net capital were below the minimum standards specified by each of the aforementioned paragraphs.

(2) For purposes of this paragraph (c)(2)(x), equity in each such specialist's market marker account shall be computed by (*i*) marking all securities positions long or

short in the account to their respective current market values, (*ii*) adding (deducting in the case of a debit balance) the credit balance carried in such specialist's market maker account, and (*iii*) adding (deducting in the case of short positions) the market value of positions long in such account.

(C) For purposes of this paragraph (c)(2)(x), a bona fide hedged position shall mean either (*1*) a long position in a security other than an option (an "underlying security"), or in a security which is currently exchangeable for or convertible into the underlying security if the conversion or exchange does not require the payment of money, which is offset by a short call option position or a long put option position for the same number of units of the same underlying security, or (2) a short position in an underlying security which is offset by a long call position or a short put position for the same number of units of the same underlying security.

(D)(*1*) For purposes of this paragraph (c)(2)(x), a bona fide spread position shall mean long and short positions in the same type (that is, put or call) of option contracts for the same number of units of the same underlying security.

(2) For purposes of this paragraph (c)(2)(x), a bona-fide straddle position shall mean long put and long call (or short put and short call) positions for the same number of units of the same underlying security.

(E) For purposes of applying the deductions required by paragraph (A) of this paragraph (c)(2)(x) in respect of positions in each such specialist's market

maker account, long and short positions in each such account shall be allocated in the following sequence:

(1) Bona fide hedged positions as defined in paragraph (C) of this paragraph (c)(2)(x) shall be constituted by first matching long or short positions in securities, other than options, against offsetting long or short call options positions taken in order of increasing exercise value and any remaining long or short positions in securities, other than options, against offsetting long or short put options positions taken in order of decreasing exercise values; provided, that in the case of long (or short) options of equal exercise value, the option possessing the greatest time to expiration shall be matched first.

(2) Thereafter, bona fide spread positions as defined in paragraph (D) of this paragraph (c)(2)(x) shall be constituted by matching long options taken in order of increasing exercise values (decreasing exercise values in the case of puts) against offsetting short options taken in order of increasing exercise values (decreasing exercise values in the case of puts); provided, that in the case of long (or short) options of equal exercise value, the option possessing the greatest time to expiration shall be matched first.

(3) Thereafter, bona-fide straddle positions as defined in paragraph (D) of this paragraph (c)(2)(x) shall be constituted by matching long (or short) call options taken in order of increasing exercise values against offsetting long (or short) put options taken in order of decreasing exercise values; provided, that in the case of long (or short) call (or put) options of equal exercise value, the

option possessing the greatest time to expiration shall be matched first.

(4) Thereafter, long or short positions not allocated pursuant to paragraphs (1), (2) or (3) above shall be treated in the manner prescribed by paragraphs (A), (A)(1) or (A)(9) of this paragraph (c)(2)(x).

(F) If at any time the deductions required in respect of any such specialist's market maker account pursuant to paragraph (A) of this paragraph (c)(2)(x) exceed the equity in the account computed pursuant to paragraph (B)(2) of this paragraph (c)(2)(x), then the broker or dealer guaranteeing, endorsing, or carrying options transactions in such account:

(1) Shall not extend further credit in the account, and

(2) Shall issue a call for additional equity which shall be met by noon of the following business day, and

(3) Shall notify by telegraph the principal office of the Commission in Washington, D.C., the regional office of the Commission for the region in which the broker or dealer maintains its principal place of business, and the Designated Examining Authorities of the specialist and the broker or dealer if the specialist fails to deposit any required equity within the time prescribed in (2) above; said telegraphic notice shall be received by the Commission's Washington, D.C. office, the Commission's regional office, and the Designated Examining Authorities not later than the close of business on the day said call is not met.

(G) If at any time a liquidating deficit exists in any such specialist's market maker account, then the broker or dealer guaranteeing, endorsing or carrying options transactions in such account shall take steps to liquidate promptly existing positions in the account.

(H) Upon written application to the Commission by the specialist and the broker or dealer guaranteeing, endorsing, or carrying options transactions in such specialist's market maker account, the Commission may approve upon specified terms and conditions lesser adjustments to net worth than those specified by paragraph (A) of this paragraph (c)(2)(x).

(xi) *Brokers or Dealers Carrying Specialists or Market Makers Accounts.* With respect to a broker or dealer who carries a market maker or specialist account, or with respect to any transaction in options listed on a registered national securities exchange for which a broker or dealer acts as a guarantor or endorser of options written by a specialist in a specialist account, the broker or dealer shall deduct, for each account carried or for each class or series of options guaranteed or endorsed, any deficiency in collateral required by paragraph (a)(6) of this section.

(xii) *Deduction from net worth for certain undermargined accounts.* Deducting the amount of cash required in each customer's or non-customer's account to meet the maintenance margin requirements of the Examining Authority for the broker or dealer, after application of calls for margin, marks to the market or other required deposits which are outstanding 5 business days or less.

(xiii) *Deduction from net worth for indebtedness collateralized by exempted securities.* Deducting, at the option of

the broker or dealer, in lieu of including such amounts in aggregate indebtedness, 4 percent of the amount of any indebtedness secured by exempted securities or municipal securities if such indebtedness would otherwise be includable in aggregate indebtedness.

EXEMPTED SECURITIES

(3) The term "exempted securities" shall mean those securities deemed exempted securities by section 3(a)(12) of the Securities Exchange Act of 1934 and rules thereunder.

CONTRACTUAL COMMITMENTS

(4) The term "contractual commitments" shall include underwriting, when issued, when distributed and delayed delivery contracts, the writing or endorsement of puts and calls and combinations thereof, commitments in foreign currencies, and spot (cash) commodities contracts, but shall not include uncleared regular way purchases and sales of securities and contracts in commodities futures. A series of contracts of purchase or sale of the same security conditioned, if at all, only upon issuance may be treated as an individual commitment.

ADEQUATELY SECURED

(5) Indebtedness shall be deemed to be adequately secured within the meaning of this section when the excess of the market value of the collateral over the amount of the indebtedness is sufficient to make the loan

acceptable as a fully secured loan to banks regularly making secured loans to brokers or dealers.

CUSTOMER

(6) The term "customer" shall mean any person from whom, or on whose behalf, a broker or dealer has received, acquired or holds funds or securities for the account of such person, but shall not include a broker or dealer or a registered municipal securities dealer, or a general, special or limited partner or director or officer of the broker or dealer, or any person to the extent that such person has a claim for property or funds which by contract, agreement, or understanding, or by operation of law, is part of the capital of the broker or dealer. *Provided, however,* That the term "customer" shall also include a broker or dealer, but only insofar as such broker or dealer maintains a special omnibus account carried with another broker or dealer in compliance with 12 CFR 220.4(b) of Regulation T under the Securities Exchange Act of 1934.

NON-CUSTOMER

(7) The term "non-customer" means a broker or dealer, registered municipal securities dealer, general partner, limited partner, officer, director and persons to the extent their claims are subordinated to the claims of creditors of the broker or dealer.

MARKET MAKER

(8) The term "market maker" shall mean a dealer who, with respect to a particular security, (i) regularly

publishes bona fide, competitive bid and offer quotations in a recognized interdealer quotation system; or (ii) furnishes bona fide competitive bid and offer quotations on request; and, (iii) is ready, willing and able to effect transactions in reasonable quantities at his quoted prices with other brokers or dealers.

PROMPTLY TRANSMIT AND DELIVER

(9) A broker or dealer is deemed to "promptly transmit" all funds and to "promptly deliver" all securities within the meaning of paragraphs (a)(2)(v) and (a)(3) of this section where such transmission or delivery is made no later than noon of the next business day after the receipt of such funds or securities. *Provided, however,* That such prompt transmission or delivery shall not be required to be effected prior to the settlement date for such transactions.

FORWARD AND PROMPTLY FORWARD

(10) A broker or dealer is deemed to "forward" or "promptly forward" funds or securities within the meaning of paragraphs (i) through (vi) of paragraph (a)(2) only when such forwarding occurs no later than noon of the next business day following receipt of such funds or securities.

READY MARKET

(11)(i) The term "ready market" shall include a recognized established securities market in which there exists independent bona fide offers to buy and sell so that

a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

(ii) A "ready market" shall also be deemed to exist where securities have been accepted as collateral for a loan by a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934 and where the broker or dealer demonstrates to its Examining Authority that such securities adequately secure such loans as that term is defined in paragraph (c)(5) of this section.

EXAMINING AUTHORITY

(12) The term "Examining Authority" of a broker or dealer shall mean for the purposes of 17 CFR 240.15c3-1 and 240.15c3-1a-d the national securities exchange or national securities association of which the broker or dealer is a member or, if the broker or dealer is a member of more than one such self-regulatory organization, the organization designated by the Commission as the Examining Authority for such broker or dealer, or if the broker or dealer is not a member of any such self-regulatory organization, the Regional Office of the Commission where such broker or dealer has its principal place of business.

EQUITY

(13) [Reserved]

(14) The term "municipal securities" shall mean those securities included within the definition of "municipal securities" in section 3(a)(29) of the Securities Exchange Act of 1934.

(d) *Debt-Equity Requirements.* No broker or dealer shall permit the total of outstanding principal amounts of its satisfactory subordination agreements (other than such agreements which qualify under this paragraph (d) as equity capital) to exceed 70 percent of its debt-equity total, as hereinafter defined, for a period in excess of 90 days or for such longer period which the Commission may, upon application of the broker or dealer, grant in the public interest or for the protection of investors. In the case of a corporation, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, par or stated value of capital stock, paid in capital in excess of par, retained earnings, unrealized profit and loss or other capital accounts. In the case of a partnership, the debt-equity total shall be the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of partners (exclusive of such partners' securities accounts) subject to the provisions of paragraph (e) of this section, and unrealized profit and loss. In the case of a sole proprietorship, the debt-equity total shall include the sum of its outstanding principal amounts of satisfactory subordination agreements, capital accounts of the sole proprietorship and unrealized profit and loss. *Provided, however,* That a satisfactory subordination agreement entered into by a partner or stockholder which has an initial term of at least three years and has a remaining term of not less than 12 months shall be considered

equity for the purposes of this paragraph (d) if: (1) It does not have any of the provisions for accelerated maturity provided for by paragraphs (b)(9)(i), (b)(10)(i) or (b)(10)(ii) of Appendix (D) (17 CFR 240.15c3-1d) and is maintained as capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section or (2) the partnership agreement provides that capital contributed pursuant to a satisfactory subordination agreement as defined in Appendix (D) (17 CFR 240.15c3-1d) shall in all respects be partnership capital subject to the provisions restricting the withdrawal thereof required by paragraph (e) of this section.

(e) *Limitation on withdrawal of equity capital.* No equity capital of the broker or dealer or a subsidiary or affiliate consolidated pursuant to Appendix C (17 CFR 240.15c3-1c) whether in the form of capital contributions by partners (excluding securities in the securities accounts of partners and balances in limited partners' capital accounts in excess of their stated capital contributions), par or stated value of capital stock, paid-in capital in excess of par, retained earnings or other capital accounts, may be withdrawn by action of a stockholder or partner, or by redemption or repurchase of shares of stock by any of the consolidated entities or through the payment of dividends or any similar distribution, nor may any unsecured advance or loan be made to a stockholder, partner, sole proprietor or employee if, after giving effect thereto and to any other such withdrawals, advances, or loans and any Payments of Payment Obligations (as defined in Appendix D (17 CFR 240.15c3-1d) under satisfactory subordination agreements which are scheduled to occur within six months following such

withdrawal, advance or loan, either aggregate indebtedness of any of the consolidated entities exceeds 1000 percentum of its net capital or its net capital would fail to equal 120 percentum of the minimum dollar amount required thereby or would be less than 5 percent of aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or, if registered as a futures commission merchant, 7 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater or in the case of any broker or dealer included within such consolidation if the total outstanding principal amounts of satisfactory subordination agreements of the broker or dealer (other than such agreements which qualify as equity under paragraph (d) of this section) would exceed 70 percent of the debt-equity total as defined in paragraph (d). *Provided,* That this provision shall not preclude a broker or dealer from making required tax payments or preclude the payment to partners of reasonable compensation.

(f) *Alternative net capital requirement.* (1)(i) A broker or dealer who is not exempt from the provisions of 17 CFR 240.15c3-3 under the Securities Exchange Act of 1934 pursuant to paragraph (k)(1) or (k)(2)(i) may elect not to be subject to the limitations of paragraph (a) of this section respecting aggregate indebtedness as defined in paragraph (c)(1) of this section and certain deductions provided for in paragraph (c)(2) of this section. *Provided,* That in order to qualify to operate under this paragraph (f), such broker or dealer shall at all times maintain net capital equal to the greater of $100,000 ($25,000 in the case of a broker or dealer effecting transactions solely in municipal securities) or 2 percent of aggregate debit

items computed in accordance with the Formula for Determination of Reserve Requirements for Brokers and Dealers (Exhibit A to Rule 15c3-3, 17 CFR 240.15c3-3a), or, if registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act, and the regulations thereunder, if greater, and shall notify the Examining Authority for such broker or dealer and the Regional Office of the Commission in which the broker or dealer has its principal place of business, in writing, of its election to operate under this provision. Once a broker or dealer has determined to operate pursuant to the provisions of this paragraph (f), he shall continue to do so unless a change is approved upon application to the Commission.

(2) In the case of a broker or dealer who has consolidated a subsidiary pursuant to Appendix C (17 CFR 240.15c3-1c), such broker's or dealer's minimum net capital requirements shall be the sum of the greater of $100,000 or 2 percent of the parent broker's or dealer's aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or, if the parent is registered as a futures commission merchant, 4 percent of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder, if greater, and the total of each consolidated broker or dealer subsidiary's minimum net capital requirements. The minimum net capital requirements of a subsidiary electing to operate pursuant to paragraph (f) of this section shall be the greater of $100,000 or 2 percent of its aggregate debit items computed in accordance with 17 CFR 240.15c3-3a, or, if registered as a futures commission merchant, 4 percent of the

funds required to be segregated by the subsidiary pursuant to the Commodity Exchange Act and the regulations thereunder, if greater. Where the subsidiary which has been consolidated has not elected to operate pursuant to paragraph (f) of this section, its minimum net capital requirement is the greater of its requirements under paragraph (a) of this section or 6 2/3 percent of its aggregate indebtedness.

(3) A broker or dealer electing to operate pursuant to this paragraph (f) shall be subject to the deductions set forth in paragraph (c)(2) of this section, except that he shall not be subject to the deductions required by paragraphs (c)(2)(vi)(G), (c)(2)(vi)(J), (c)(2)(vi)(K)(i), and (c)(2)(vi)(M) and shall in lieu thereof deduct the following amounts under paragraph (c)(2) of this section in its computation of net capital:

(i) *Convertible Debt Securities.* In the case of a debt security not in default which has a fixed rate of interest and a fixed maturity date and which is convertible into an equity security, the deduction shall be as follows: If the market value is 100 percent or more of its principal amount, the deduction shall be determined as specified in (ii) below; if the market value is less than its principal amount the deduction shall be determined as in paragraph (c)(2)(vi)(F) of this section if such securities are rated as required by paragraph (c)(2)(vi)(F) of this section:

(ii) *Other Securities.* In the case of all securities or evidence of indebtedness, except as provided in Appendix (A), 17 CFR 240.15c3-1a, which are not included in any of the percentage categories specifically enumerated

in paragraph (A)-(H) or (K)(ii) of paragraph (c)(2) (vi) of this section, the deduction shall be 15 percent of the market value of the long positions. To the extent the market value of short positions exceeds 25 percent of the market value of long positions, there shall be a percentage deduction equal to 30 percent of the market value of such excess. *Provided,* That no deduction need be made in the case of (A) a security which is convertible into or exchangeable for other securities within a period of 90 days, subject to no conditions other than the payment of money, and the other securities into which such security is convertible or for which it is exchangeable are short in the account of such broker or dealer or (B) a security which has been called for redemption and which is redeemable within 90 days. *Provided further,* That at the option of the broker or dealer, securities described in paragraph (c)(2)(vi)(I) of this section may be included in the computation of the deductions under this paragraph (f)(3)(ii) if a lesser deduction would result.

(iii) *Undue Concentrations.* In the case of money market instruments, or securities of a single class or series of an issuer, including any option written, endorsed or held to purchase or sell securities of such a single class or series of an issuer (other than "exempted securities"), and securities underwritten (in which case the deduction provided for herein shall be applied after 11 business days) which are long or short in the proprietary or other accounts of a broker or dealer and which have a market value of more than 10 percent of the "net capital" of a broker or dealer before the application of paragraphs (c)(2)(vi), (f)(3) of this section or Appendix (A) (17 CFR 240.15c3-1a) there shall be an additional deduction from

net worth equal to 50 percent of the percentage deduction otherwise provided by this section or Appendix (A) (17 CFR 240.15c3-1a) (in the case of securities described in paragraph (f)(3)(i) of this section which receive a 30% deduction or securities described in paragraph (f)(3)(ii) of this section the deduction required by this paragraph (f)(3)(iii) shall be 15% on that portion of the securities position in excess of 10 percent of the "net capital" of the broker or dealer before the application of paragraphs (c)(2)(vi), (f)(3)(i) and (ii) of this section and Appendix (A) (17 CFR 240.15c3-1a). This provision shall apply notwithstanding any long or short position exemption provided for in paragraphs (c)(2)(vi)(I) or (f)(3)(ii) of this section (except for a long or short position exemption arising out of the first provisio to paragraph (f)(3)(ii) of this section) and the deduction on any such exempted position shall be 15% of that portion of the position in excess of 10% of net capital before the application of paragraph (c) (2)(vi), paragraphs (f)(3) (i) and (ii) of this section and Appendix (A) (17 CFR 240.15c3-1a).

Provided, That such additional deductions shall be applied in the case of equity securities only on the market value in excess of $10,000 or the market value of 500 shares, whichever is greater, or $25,000 in the case of a debt security. *Provided further,* That any specialist who is subject to a deduction required by this paragraph (f)(3)(iii) of this section respecting his specialty stock, who can demonstrate to the satisfaction of the Examining Authority for such broker or dealer that there is sufficient liquidity for such specialist's specialty stock and that such deduction need not be applied in the public interest for the protection of investors may on a proper showing

to such Examining Authority have such undue concentration deduction appropriately decreased but in no case shall the deduction prescribed in paragraph (f)(3)(ii) of this section be reduced. Each such Examining Authority shall make and preserve for a period of not less than 3 years a record of each application granted pursuant to this subdivision, which shall contain a summary of the justification for the granting of the application. *Provided further,* This provision will be applied to an issue of municipal securities having the same security provisions, date of issue, interest rate, day, month and year of maturity only if such securities have a market value in excess of $500,000 in bonds ($5,000,000 in notes) or 10% of tentative net capital, which ever is greater, and are held in position longer than twenty (20) business days from the date the securities are received by the syndicate manager from the issuer.

(4) In the case of any deductions for open contractual commitments provided for in paragraph (c)(2)(viii) of this section, the deduction for securities which are described in paragraph (f)(2)(ii) shall be 30 percent.

(5) In addition to the foregoing, brokers or dealers electing this alternative shall:

(i) Make the computation required by 17 CFR 240.15.3-3(e) and set forth in Exhibit A (17 CFR 240.15c3-3a) on a weekly basis and, in lieu of the 1 percent reduction of certain debit items required by Note B(2) in the computation of their Exhibit A requirement, reduce aggregate debit items in such computation by 3 percent;

(ii) Include in Items 7 and 8 of Exhibit A (17 CFR 240.15c3-3a) the market value of items specified therein over 7 business days old;

(iii) Exclude credit balances in accounts representing amounts payable for securities not yet received from the issuer or its agent which securities are specified in paragraphs (c)(2)(vi) (A) and (E) of this section and any related debit items form the Exhibit A requirement for three business days.

(iv) Deduct from net worth in computing net capital 1% of the contract value of all failed to deliver contracts or securities borrowed which were allocated to failed to receive contracts of the same issue and which thereby were excluded from Items 11 or 12 of Exhibit A, 17 CFR 240.15c3-3a.

(Secs. 15 and 23, 15 U.S.C. 78o and 78w))
[40 FR 29799, July 16, 1975, as amended at 40 FR 41521, Sept. 8, 1975; 40 FR 57788, Dec. 12, 1975; 41 FR 5278, Feb. 5, 1976; 41 FR 24119, June 15, 1976; 41 FR 39017, 39019, Sept. 14, 1976; 41 FR 44701, Oct. 12, 1976; 42 FR 2061, Jan. 10, 1977; 42 FR 27223, May 27, 1977; 42 FR 31776, 31780, June 23, 1977; 42 FR 38902, Aug. 1, 1977; 43 FR 9271, Mar. 7, 1978; 43 FR 10551, Mar. 14, 1978; 44 FR 1974, Jan. 9, 1979; 44 FR 34885, June 15, 1979; 47 FR 3517, Jan. 25, 1982; 47 FR 21772, May 20, 1982]

EDITORIAL NOTE For an interpretative release relating to § 240.15c3-1, see 41 FR 5279, Feb. 5, 1976.

Supreme Court, U.S.
FILED
MAY 10 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1424

In the Supreme Court of the United States

OCTOBER TERM, 1988

THE STUART-JAMES COMPANY, INC. AND MARC N. GEMAN, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WILLIAM C. BRYSON
Acting Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LUCINDA O. MCCONATHY
Special Counsel
Securities and Exchange Commission
Washington, D.C. 20549

QUESTION PRESENTED

Whether the Securities and Exchange Commission, in affirming a censure and $500 fine imposed on petitioners by the National Association of Securities Dealers, reasonably interpreted the phrase "unrealized profit" as used in the Commission's net capital rule not to include an "unallocated expense reserve" received by an underwriter.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	7
Conclusion	13

TABLE OF AUTHORITIES

Cases:

Aleknagik Natives, Ltd. v. *United States*, 635 F. Supp. 1477 (D. Alaska 1985), aff'd, 806 F.2d 924 (9th Cir. 1986)	10
Anderson v. *Butz*, 550 F.2d 459 (9th Cir. 1977)	10
Bowles v. *Seminole Rock Co.*, 325 U.S. 410 (1945)	7
Chamber of Commerce of United States v. *OSHA*, 636 F.2d 464 (D.C. Cir. 1980)	9
Herron v. *Heckler*, 576 F. Supp. 218 (N.D. Cal. 1983)	10
Kahn v. *United States*, 753 F.2d 1208 (3d Cir. 1985)	12
Lewis v. *Weinberger*, 415 F. Supp. 652 (D.N.M. 1976)	10
Lowell H. Listrom & Co. v. *SEC*, 803 F.2d 938 (8th Cir. 1986)	7
L. R. Willson & Sons, Inc. v. *Donovan*, 685 F.2d 664 (D.C. Cir. 1982)	9
Morton v. *Ruiz*, 415 U.S. 199 (1974)	10
Nguyen v. *United States*, 824 F.2d 697 (9th Cir. 1987)	11
Perri v. *Department of the Treasury*, 637 F.2d 1332 (9th Cir. 1981)	11
Powderly v. *Schweiker*, 704 F.2d 1092 (9th Cir. 1983)	10
Udall v. *Tallman*, 380 U.S. 1 (1965)	7
United States v. *Heller*, 726 F.2d 756 (Temp. Emer. Ct. App. 1983)	9
United States v. *Larionoff*, 431 U.S. 864 (1977)	7
United States v. *Mowat*, 582 F.2d 1194 (9th Cir.), cert. denied, 439 U.S. 967 (1978)	11-12
Welch v. *United States*, 750 F.2d 1101 (1st Cir. 1985)	11

Statutes and regulations:

	Page
Administrative Procedure Act, 5 U.S.C. 551 *et seq.*	5
5 U.S.C. 552(a)(1) (Freedom of Information Act)	6, 11, 12
5 U.S.C. 552(a)(1)(D)	6, 10
5 U.S.C. 553(b)(A)	6
Securities Exchange Act of 1934, § 15(c)(3), 15 U.S.C. 78*o*(c)(3)	2
17 C.F.R.:	
Section 240.15c3-1	2
Section 240.15c3-1(a)	2
Section 240.15c3-1(c)(2)(viii)	3

Miscellaneous:

1 K.C. Davis, *Administrative Law Treatise* (1979)	13
National Association of Securities Dealers Manual (1984)	13

In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1424

THE STUART-JAMES COMPANY, INC. AND
MARC N. GEMAN, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 857 F.2d 796. The opinion of the Securities and Exchange Commission, Securities Exchange Act Release No. 24,590 (June 15, 1987) (Pet. App. 14a-19a), is unofficially reported at 38 S.E.C. Docket 1118.

JURISDICTION

The judgment of the court of appeals was entered on September 20, 1988. A petition for rehearing was denied on November 17, 1988 (Pet. App. 13a). The petition for a writ of certiorari was filed on February 15, 1989. The jurisdiction of the Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner The Stuart-James Company, Inc. (Stuart-James) is a securities broker-dealer firm that is registered with the Securities and Exchange Commission (Commission) and is a member of the National Association of Securities Dealers (NASD). Petitioner Marc N. Geman is the firm's executive vice-president. Petitioners contend that the court of appeals erred in affirming a Commission order which, in turn, affirmed disciplinary action taken against petitioners by the NASD based on a finding that petitioners had violated the net capital rule, Securities Exchange Act Rule 15c3-1, 17 C.F.R. 240.15c3-1 (Pet. App. 21a-84a).

1. The net capital rule was promulgated by the Commission pursuant to its statutory authority "to provide safeguards with respect to the financial responsibility" of brokers and dealers. See Section 15(c)(3) of the Securities Exchange Act of 1934, 15 U.S.C. 78*o*(c)(3). The net capital rule prescribes minimum liquidity standards for broker-dealer firms to assure that they maintain sufficient liquid assets to satisfy customer claims promptly. Essentially, the rule requires that a firm's "aggregate indebtedness" never exceed 1500% of its "net capital," as each term is defined in the rule. 17 C.F.R. 240.15c3-1(a). A broker-dealer is required to be in compliance with the rule—that is, to have the required net capital—at all times.

The net capital rule requires a broker-dealer to take account of its underwriting commitments in determining its compliance with the rule. A broker-dealer may underwrite securities on a "firm commitment" basis. In such a transaction, the broker-dealer purchases securities from the issuing company at a discount from the full public offering price and assumes the risk of reselling those securities to the public. The difference between the price the under-

writer pays to the issuer and the public offering price is known as a "concession." The underwriter retains the concession as compensation, although part of it may be paid to its salespersons as commissions. See Pet. App. 10a. In addition, an underwriter generally receives an expense allowance from the issuer. This allowance may be limited to actual expenses or it may be a fixed amount that the underwriter is entitled to retain even if actual expenses are less.

In a firm commitment offering, an underwriter assumes the risk that it will not be able to resell the securities to the public at the full offering price and that they will decline in value. Accordingly, the Commission's net capital rule requires a broker-dealer, at the commencement of the offering, to deduct from its net capital a so-called "haircut" of 30% of the public offering price of the securities. 17 C.F.R. 240.15c3-1(c)(2)(viii). The net capital rule, however, allows the haircut to be reduced by the amount of the firm's "unrealized profit" from the offering. *Ibid.*

2. On November 1, 1984, Stuart-James entered into a firm commitment underwriting agreement with U.S. Electronics Group (USEG). Pet. App. 16a. Stuart-James agreed to purchase $1,740,000 worth of securities in return for a concession of $174,000, a 10% discount from the full public offering price. *Ibid.* The concession was to serve as Stuart-James' compensation for underwriting the transaction. *Id.* at 3a. The underwriting agreement also called for USEG to pay to Stuart-James an "unallocated expense reserve" of $120,000, under an arrangement in which Stuart-James did not have to account to USEG for its actual expenses, but could keep any unexpended portion of the reserve for itself. *Id.* at 16a.

On November 13, 1984, the NASD staff ascertained that when Stuart-James entered into the USEG underwriting agreement, its net capital was not sufficient to

allow it to underwrite the transaction while staying in compliance with the net capital rule. Pet. App. 3a. Thereafter, a District Business Conduct Committee of the NASD (DBCC) filed a complaint against petitioners alleging that they had conducted a securities business with insufficient net capital. *Id.* at 4a. After a hearing, the DBCC found that petitioners had violated the net capital rule, but did not impose sanctions on petitioners because it found mitigating circumstances. *Ibid.* On review, the NASD Board of Governors agreed that petitioners had violated the net capital rule, but disagreed with the DBCC's finding of mitigating circumstances. Accordingly, the Board imposed a sanction on petitioners of a censure and a fine of $500. *Ibid.*

3. Petitioners appealed to the Commission from the NASD's disciplinary action. Pet. App. 14a-20a. Independently reviewing the record, the Commission affirmed the sanctions. *Id.* at 15a. Petitioners contended that the NASD had erred in finding a net capital deficiency because it had incorrectly computed the "unrealized profit" that Stuart-James expected to earn from the USEG underwriting. Petitioners asserted that its "unrealized profit" included not only the concession but also the "unallocated expense reserve" it received, because both items represented revenue to the underwriter. Pet. App. 16a-17a. The NASD, however, had included only the concession in determining Stuart-James' "unrealized profit." *Ibid.*

The Commission rejected petitioners' argument. Pet. App. at 17a-18a. It explained that "the precise amount of [unrealized profit] cannot be definitely ascertained at the time the underwriter makes his commitment," but "it is reasonable to assume that the concession or discount an underwriter is slated to receive contains a substantial element of profit." *Id.* at 17a. Thus, the Commission noted,

both its staff and the NASD have "consistently treated the entire amount of the underwriter's concession as unrealized profit in determining net capital," even though some portion of the concession may be used for expenses. *Ibid.* In contrast, the purpose of the expense reserve "is to reimburse the underwriter for expenses incurred in connection with the underwriting" (*ibid.*), and the expense reserve, therefore, cannot be assumed to represent "unrealized profit" to the underwriter. The Commission noted that the USEG prospectus had even disclosed that the "expense allowance at issue might not be sufficient to cover the firm's expenses." *Id.* at 18a. Accordingly, the Commission agreed with the NASD that under a proper interpretation of the term "unrealized profit," Stuart-James could not reduce its haircut from the USEG transaction by treating both the amount of its expense allowance as well as the concession as "profit."

4. The court of appeals denied petitioners' petition for review. Pet. App. 1a-12a. The court concluded that the Commission's interpretation of the term "unrealized profit" to include the concession to Stuart-James, but not the expense allowance, was reasonable. The court also found that the Commission's interpretation had not been applied to petitioners in violation of the Administrative Procedure Act (APA), 5 U.S.C. 551 *et seq.* Pet. App. 10a-11a.

The court initially observed that the Commission's interpretation "of regulations that it has promulgated under a statute Congress has charged it with enforcing" is entitled to "considerable deference." Pet. App. 9a. The court then explained that "[i]n interpreting the net capital rule, the Commission is charged with the paradoxical task of measuring something that does not yet exist: the 'unrealized profit' on a transaction that has not yet occurred." *Ibid.* The Commission's choice to do so by using the firm's concession as a measure of its "unrealized profit" is "a

reasonable one," considering that "[t]his measure is necessarily only an approximation of actual profits, omitting several other factors that will in practice raise or lower the actual profits that a firm realizes on a transaction." *Id.* at 10a. The court added that "there is no indication that the Commission has ever interpreted the phrase differently." *Ibid.*

The court also rejected petitioners' contention that the Commission had improperly failed to publish its interpretation of the net capital rule under the APA's rule making provisions, 5 U.S.C. 553(b)(A), or under the Freedom of Information Act (FOIA) provisions of the APA, 5 U.S.C. 552(a)(1). Pet. App. 10a-11a. The APA's rulemaking provisions did not apply because those provisions require publication only of "substantive rules," and specifically exclude from that requirement "interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice." 5 U.S.C. 553(b)(A). The Commission's interpretation of the net capital rule, the court explained, "clearly falls within [the] statutory rubric" of an interpretive rule and thus did not have to be published. Pet. App. 11a. Likewise, the FOIA publication provisions do not apply to the Commission's interpretation of "unrealized profit." Those provisions apply only to "substantive rules," "statements of general policy," or "interpretations of general applicability," 5 U.S.C. 552(a)(1)(D), and the Commission's interpretation of "unrealized profit" is not one of these. Pet. App. 11a.

The court found no abuse of discretion in the Commission's resolution of the precise meaning of "unrealized profit" in an adjudicatory proceeding in which petitioners were sanctioned. Pet. App. 11a-12a. While it viewed that procedure as not an "ideal" one, the court pointed out that "petitioners were remiss in proceeding with the USEG underwriting without seeking a clarification of the mean-

ing of that term and ensuring that they were in compliance with the net capital rule." *Id.* at 12a. The court thus affirmed the finding of a violation and the imposition of a "mild sanction" on petitioners. *Ibid.*

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioners renew their contention (Pet. 3-6) that the term "unrealized profit" under the net capital rule should be interpreted to include not only an underwriter's concession, but also its unallocated expense allowance. The Commission's interpretation to the contrary, however, is well within the agency's discretion to explain the meaning of its rule. Because the Commission is interpreting its own rule, promulgated under a statute that Congress has charged it with administering, the court of appeals correctly decided that the interpretation is entitled to substantial deference. The Commission's interpretation is "of controlling weight unless it is plainly erroneous or inconsistent with the regulation." *United States* v. *Larionoff*, 431 U.S. 864, 872 (1977) (quoting *Bowles* v. *Seminole Rock Co.*, 325 U.S. 410, 414 (1945)). See also Udall v. *Tallman*, 380 U.S. 1, 16 (1965) (this Court "shows great deference to the interpretation given the statute by the officers or agency charged with its administration. * * * When the construction of an administration regulation rather than a statute is in issue, deference is even more clearly in order."); *Lowell H. Listrom & Co.* v. *SEC*, 803 F.2d 938, 941 (8th Cir. 1986). The Commission's interpretation of the phrase "unrealized profit" is plainly not subject to question under that standard.

The Commission uses an objective, bright-line measure to determine a broker-dealer's "unrealized profit" from a firm commitment underwriting. It includes an underwriter's entire concession in "unrealized profit," and excludes from that category the firm's "unallocated expense" allowance. Although there may be an element of expense in the underwriter's concession, and an element of profit in an expense allowance, the Commission's approach focuses on the general nature of those different types of payments for purposes of adjusting an underwriter's "haircut" as a result of a public offering. "[A]t least in the common situation where the underwriter is separately reimbursed for many of its out-of-pocket expenses, it is reasonable to assume that the concession or discount an underwriter is slated to receive contains a substantial element of profit," while "[t]he same assumption cannot be made for the expense reserve." Pet. App. 17a.[1]

The Commission's interpretation of the net capital rule, in contrast to that of petitioners, accords with the rule's plain language. The net capital rule provides that a haircut may be reduced by "unrealized profit"—not "revenue," or "payment," or "proceeds," or "receipts." Petitioners, however, ignore this language by arguing that "there is no reason to treat concessions differently from such [expense] allowances, because both mean *revenue* to the company." Pet. 6 (emphasis added). "Unrealized profit" is not equiva-

---

[1] Even if some portion of the expense allowance does include an element of profit, the Commission's formula permits a rough correction for that possibility because the entire concession is included, even though a portion of that may actually be used for the underwriter's expenses. Under the interpretation urged by petitioners (Pet. 5-6), instead of being required to *correct* the overstatement of profit that results from including the entire concession as profit, a firm would be permitted to *exaggerate* it by counting its entire expense allowance as unrealized profit in addition to the entire concession.

lent to "unrealized revenue," however, because profit is what remains of revenue after expenses are paid. Counting both the concession and the expense allowance as unrealized profit would result in all expenses being treated as though they were profits, a result at variance with the rule's text and purposes.[2]

The Commission's approach also greatly simplifies administration of the net capital rule. Any other reasonably accurate formula would likely require broker-dealers to construct estimates of their anticipated expenses and profit for each underwriting transaction, defeating the Commission's purpose of assuring ready compliance with the net capital rule in this context. Neither the NASD nor the Commission would have an efficient means of testing such broker-dealer predictions without detailed and painstaking review, and a brokerage firm could not know in advance whether its predictions about its "unrealized profit"—and the net capital calculation based on those predictions—would be sufficient to obtain NASD approval to enter an underwriting. In contrast, the Commission's interpretation allows its staff, the NASD, and the broker-dealer to calculate the broker-dealer's net capital position on an objective basis at the commencement of an

---

[2] Accordingly, the cases on which petitioners relies (Pet. 8-9) for the general notion that an agency may not use an interpretation to depart from the language of a rule are completely inapplicable in this case. See *L. R. Willson & Sons, Inc.* v. *Donovan*, 685 F.2d 664, 675 (D.C. Cir. 1982) (rejecting agency interpretation of "impractical" that strayed from its "ordinary meaning"); *Chamber of Commerce of United States* v. *OSHA*, 636 F.2d 464 (D.C. Cir. 1980) (agency could not interpret its statute and rules to require that employee must be compensated for accompanying OSHA inspector on a plant tour without going through APA rulemaking provisions); *United States* v. *Heller*, 726 F.2d 756, 762 (Temp. Emer. Ct. App. 1983) (discussing general principles of construing regulations).

offering, without relying on the broker-dealer's predictions about its anticipated expenses.

2. Petitioners next insist (Pet. 8-10) that because the Commission has not published its interpretation of the term "unrealized profit" in the Federal Register, it cannot apply that interpretation to them. Contrary to petitioners' contention, however, the APA, 5 U.S.C. 552(a)(1)(D), does not require such publication. That section requires publication of "statements of general policy and interpretations of general applicability." *Ibid.* Publication is not required when an administrative interpretation only clarifies or explains an existing law or regulation. See, *e.g.*, *Anderson* v. *Butz*, 550 F.2d 459, 463 (9th Cir. 1977). Publication is required only when an agency "adopt[s] new rules or substantially modif[ies] existing rules, regulations, or statutes and thereby cause[s] a direct and significant impact upon the substantive rights of the general public." *Lewis* v. *Weinberger*, 415 F. Supp. 652, 659 (D.N.M. 1976); see also *Powderly* v. *Schweiker*, 704 F.2d 1092, 1098 (9th Cir. 1983) (interpretation of term in Social Security Act and regulation did not have to be published in Federal Register because it only explained what the more general term in the Act and regulation provided); *Aleknagik Natives, Ltd.* v. *United States*, 635 F. Supp. 1477 (D. Alaska 1985), aff'd, 806 F.2d 924 (9th Cir. 1986) (interpretation of statute by Secretary of the Interior was not required to be published under the APA because it merely clarified or explained what the Secretary believed the statute meant).[3]

---

[3] The cases relied on by petitioners (Pet. 9) are not to the contrary. See *Morton* v. *Ruiz*, 415 U.S. 199, 231 (1974) (APA provision held applicable to eligibility requirements imposed by an agency because the agency was making new rules to fill a gap left by Congress); *Herron* v. *Heckler*, 576 F. Supp. 218, 230, 233 (N.D. Cal. 1983) (certain un-

The Commission's interpretation of the term "unrealized profit" was just such a clarification or explanation. It did not introduce new concepts into the rule or new requirements for the calculation of net capital. Rather, as the court of appeals noted, it "merely explained an already existing regulation." Pet. App. 11a.

Even if the APA had required publication of the Commission's intepretation of the term "unrealized profit," the failure to do so would not prevent the imposition of sanctions on petitioners in the circumstances of this case. Petitioners rely (Pet. 9) on the last paragraph of Section 552(a)(1) of the APA, which provides, "Except to the extent that a person has actual and timely notice of the terms thereof, a person may not * * * be adversely affected by, a matter required to be published in the Federal Register and not so published." Consistent with the underlying purpose of the APA, however, the courts have held that enforcement of an unpublished interpretation should be barred only if enforcement would be unfair or arbitrary under the particular facts presented. *Nguyen* v. *United States*, 824 F.2d 697, 701 (9th Cir. 1987). When the party subject to sanction has reason to know that his conduct is prohibited, and the unpublished interpretation is consistent with the published statute or regulation being interpreted, the courts have allowed the unpublished interpretation to be enforced. *E.g.*, *Welch* v. *United States*, 750 F.2d 1101, 1110 (1st Cir. 1985); *Perri* v. *Department of the Treasury*, 637 F.2d 1332, 1337 (9th Cir. 1981); *United States* v.

---

published eligibility requirements held not enforceable because they introduced entirely new concepts not found in the governing statute and regulations).

Mowat, 582 F.2d 1194, 1199-1204 (9th Cir.), cert. denied, 439 U.S. 967 (1978). *Cf. Kahn* v. *United States*, 753 F.2d 1208, 1222-1223 n.8 (3d Cir. 1985). See also 1 K. C. Davis, *Administrative Law Treatise* § 5:12, at 348 (1979). The Commission's interpretation of the term "unrealized profit" is consistent with the language and purposes of the net capital rule, and petitioners had ample reason to know of that interpretation.[4] Accordingly, they have no cause for complaint under Section 552(a)(1) of the APA.

---

[4] Petitioners knew from the published regulation that profits, not revenues, are permitted to reduce the haircut that must be taken on a firm-commitment underwriting. They also knew prior to the violation in this case that the NASD treated only a portion of the revenues from a firm-commitment underwriting as unrealized profit for purposes of the net capital rule. When petitioners requested the NASD's advance permission to engage in the USEG underwriting, as required by NASD rules (NASD Manual ¶ 2151 (1984)), the NASD staff initially denied the request because they calculated that the firm did not have enough net capital. The calculation was made treating 10% of the offering amount as unrealized profit. R. 130, 166. Thus, petitioners knew that the NASD did not consider as "unrealized profit" the total revenues, which amounted to approximately 16% of the underwriting when the expense allowance was added to the concession. Since the concession in the proposed underwriting was 10% of the offering, the petitioners had notice that the concession was the only part of revenues to be treated as unrealized profit in calculating net capital.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LUCINDA O. MCCONATHY
Special Counsel
Securities and Exchange Commission

MAY 1989

U.S. GOVERNMENT PRINTING OFFICE: 1989—241-699:00246